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CABO VERDE

SELECTED ISSUES

March 13, 2018

Approved By
African Department

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CONTENTS

LOSS OF CORRESPONDENT BANKING RELATIONSHIPS IN CABO VERDE: AN APPLICATION OF THE MINIMUM SCOPE FRAMEWORK[1]

A. Introduction

1. This paper provides an overview of the nature and scope of corresponding banking relationships (CBRs) withdrawals in Cabo Verde and discusses policy options to address this challenge. The paper reports the results of a bank level survey and employs the minimum scope framework developed by Grolleman and Jutrsa (2017) on Cabo Verdean bank level data for the period 2014-2017.

2. The international network of CBRs is essential for international trade and financial interactions.[2] CBRs provide the essential infrastructure through which global payments, trade and commerce are performed (IMF, 2017). However, in recent times large international banks have started terminating their CBRs with smaller local and regional banks from various jurisdictions around the world. In some instances, the CBR has not been terminated but has been scaled down restricting access to financial services for categories of customers, types of businesses such as remittances and offshore banking. Cabo Verde has not escaped this phenomenon. According to the FSB (2017), the number of active correspondent banks in Cabo Verde declined by 4 percent between 2012 and 2016 and the volume of flows using SWIFT data increased by 16.9 percent during the same period. Although the economic impacts of the withdrawal of CBRs have so far been minimal, it can be potentially significant because of the country's reliance on remittances and migrant deposits.

B. Global Trends

3. CBRs have been under pressures in several countries. This development largely reflects correspondent banks' re-assessment of risk and profitability relationships as well as a revision of their broader business strategy to reduce cost and cross-border risk exposures by limiting engagement with categories of customers, businesses and jurisdictions. According to a World Bank survey, smaller jurisdictions in Africa, the Caribbean, Central Asia, and Europe were most affected by the reduction in transactions by banks in the U.S and the U.K (World Bank, 2015). The withdrawal of CBRs is also seen to a lesser extent in some larger economies in Latin America, including Mexico. In the Middle East and North Africa, countries under economic and trade sanctions are mostly affected by the withdrawal of CBRs (IMF/UAB, 2015). The coverage of CBR issues across Article IV consultations where this issue was deemed macro critical or where discussion was agreed with the authorities, highlights similar regional pockets of CBR withdrawal as identified in the

[1] Prepared by Charles Amo-Yartey

[2] CBRs are one part of the cross-border payments made between banks. Trade finance, portfolio flows, and investment (swaps, derivatives, and other securities) and wealth management functions also facilitate payments for goods, services, and financial assets.

surveys, namely in the Caribbean, the small islands of the Pacific, the Middle East and North Africa (MENA) region, Central Asia, and Africa.

4. **Globally, the drivers of CBRs withdrawal are multiple and interrelated**. IMF staff discussions with global banks and regulators in the context of Article IV and FSAPs have identified a number of factors influencing global banks decisions to severe CBRs. These include broader re-alignment of banks' business models, increasing economic, financial and reputational risks, deficiencies in the AML/CFT framework, and tighter post crisis regulation. In the Germany FSAP, for instance, IMF staff noted that the withdrawal of CBRs by German banks appeared to have been driven mainly by business and risk return considerations, lower risk appetite, and the implementation of risk-based approach under international standards (IMF, 2017). Compliance with regulatory requirements concerning AML/CFT, tax transparency, economic and trade sanctions, including for customer due diligence, transactions monitoring, record keeping, and suspicious transaction reporting have been associated with increasing costs for most global banks. Against the background of reduced profitability since the global financial crisis and imposition of high fines for misconduct and/or criminal behavior of banks, concerns about the cost of potential litigation and punitive measures are rising[3].

5. **The economic and financial stability impact of the withdrawal of CBRs on most countries has been minimal.** So far, cross-border payments have remained stable and economic activity has been largely unaffected, despite a recent slight decrease in the number of CBRs. This reflects the ability of banks in affected countries to find alternative arrangements, including by replacing lost CBRs with other second or third tier financial institutions or alternative arrangements media to transfer funds across borders. In a World Bank study, many of the affected countries reported that maintaining existing CBRs has been costly, including newly imposed minimum activity thresholds, higher cost of due diligence often passed on to customers, and pressure on banks to limit exposure to certain categories of customers (World Bank, 2015).

C. The Importance of CBRs

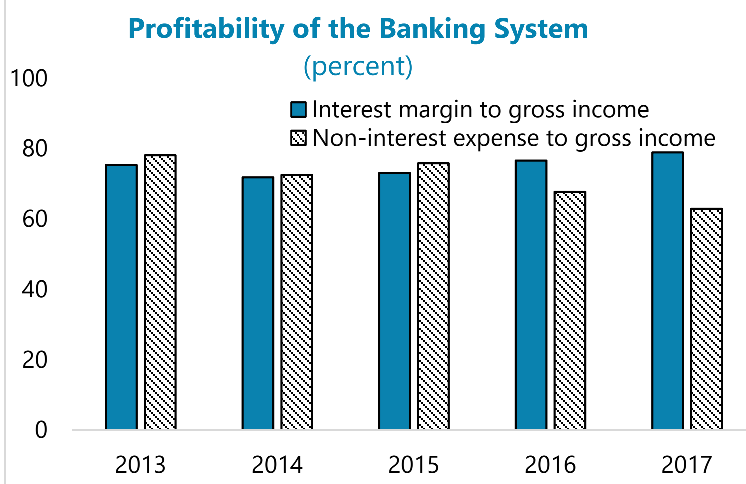
6. **SWIFT (2011) defines correspondent banking as banking services, mainly payments, cash management and trade services, provided by banks to customers via other banks.** More broadly, correspondent banking involves one bank (the correspondent) providing a deposit account or other liability accounts and related services, to another bank (the respondent), often including its affiliates. This arrangement normally requires the exchange of messages to settle transactions by debiting and crediting those accounts.

7. **Correspondent banking plays an active role in supporting economic activity.** It is the main channel to deliver cross border banking services. According to SWIFT (2011), bank to bank settlement accounted for 67 percent of the volume of cross border customer payments on SWIFT in August 2011. Besides facilitating financial transactions, there are other benefits associated with

[3] It is important to note that CBR activities are low margin. Thus, in small jurisdictions and for small banks, the increased due diligence cost makes the business less profitable even if the AML/CFT framework is strong.

CBRs. Well-developed correspondent banking networks can help local banks in developing countries bridge the knowledge, technology and risk management gaps.

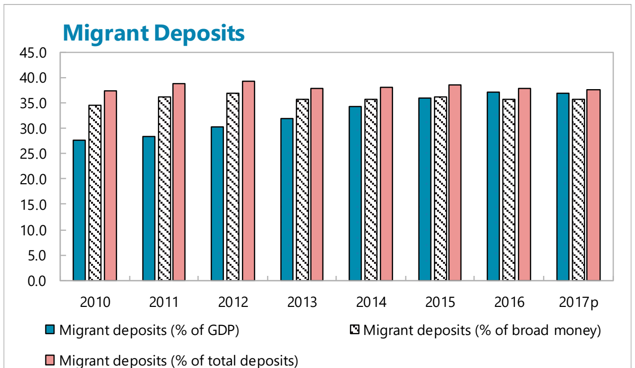
8. **The potential economic impacts as a result of a continued loss of CBRs are significant**. A key concern is that in some countries, financial fragilities can be accentuated as cross-border flows are concentrated through few CBRs or maintained through alternative arrangements. In Cabo Verde, the withdrawal of CBRs could undermine a banking system struggling with high non-performing loans. As CBRs become unavailable, banks are likely to resort to nested relationships with other banks or parent abroad, which are more expensive arrangements involving longer payment chains[4]. Clearing and settlement services are also likely to encounter high cost and prolonged payment checking procedures. A decline in non-interest income resulting from more expensive CBRs will likely reduce banking system profitability and lending and allows banks less balance sheet capacity to offset losses from higher NPLs resulting in potentially lower capital.



Sources: Central Bank of Cabo Verde; and IMF Staff estimates.

9. **If CBRs continue to be terminated or restricted, this could affect the Cabo Verdean economy through reduced international trade, migrant deposits, remittances, and investment flows**. Given the country's reliance on remittances and migrant deposits, much of the strain is likely to be felt by the remittances sector (remittances and migrant deposits) possibly impacting financial stability.

- **Migrant deposits**. The banking system and the economy relies significantly on deposits from the Cabo Verdean diaspora. Over the last decade, the country has experienced a strong accumulation of emigrant deposits. These deposits have provided much-needed foreign exchange to the country. Migrant deposits represent

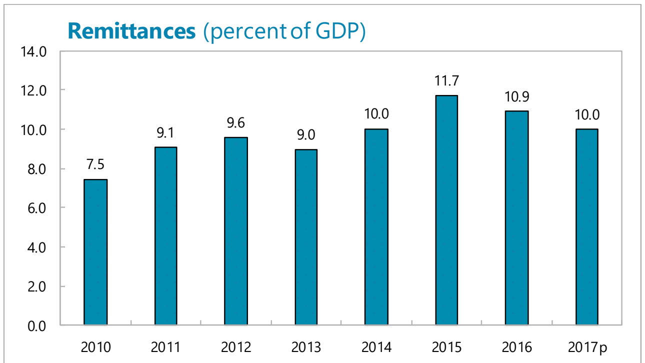


Sources: Cabo Verdean authorities; and IMF staff estimates.

[4] A nested CBR is a relationship that offers CBR in a currency different from the country in which the correspondent is domiciled (for example, a US bank offering an account and services in euros). Use of nested relationships with 2nd, 3rd tier banks, which are lower rated, could also have capital implications as those CBRs carry higher risk weights reducing capital adequacy ratios.

38 percent of total deposits (about 37 percent of GDP); annual inflows have averaged 2½ percent of GDP during 2015-17.

- **Remittances.** Continued loss of CBRs could result in higher remittance cost and increased use of non-transparent remittance channels thereby reducing the government's ability to monitor transactions. Annual remittances currently represent about 11 percent of GDP. Given their importance, any decline in remittances could have a significant impact on economic growth reducing buffers and resilience to external shocks.

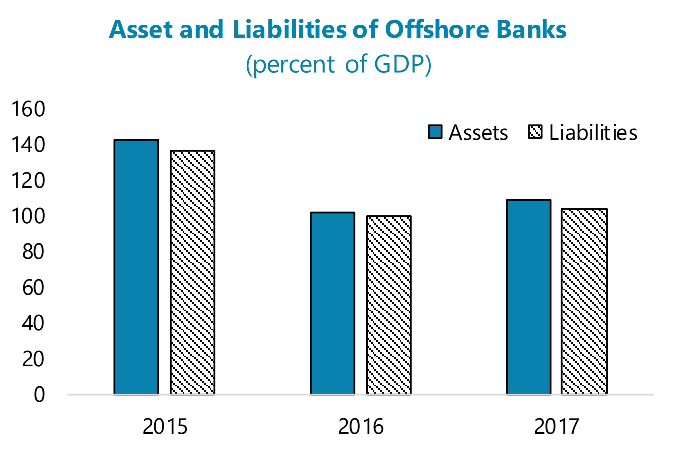


Sources: Cabo Verdean authorities; and IMF staff estimates.

- **International trade and commerce**. Cabo Verde is a highly open economy relying significantly on international trade, including tourism. The country imports of basic commodities such as food and medicine are significant. Trade openness measured as the sum of exports and imports of goods and services as percentage of GDP is 101 percent, higher than the sub-Saharan Africa average of 60 percent. An increase in cost of making international payments resulting from the withdrawal of CBRs may undermine economic activity.

- **Financial flows**. The withdrawal of CBRs could constrain foreign investment, including through challenges in repatriating reinvested earnings. Financial flows, including foreign direct investment are important for financing investment, particularly in the tourism sector. For instance, FDI accounted for roughly 6 percent of GDP in 2016.

- **Offshore banks**. Cabo Verde has a sizable offshore banking sector (similar in size to the domestic banking sector) with limited links to the domestic economy. The total asset of the sector reached 107 percent of GDP in September 2017. Offshore banks are higher risk since CBRs are particularly important part of their core business[5]. The financial intermediation role of offshore banks in the country has declined



Sources: Central Bank of Cabo Verde; and IMF Staff estimates.

[5] Offshore banks are required to have active CBRs before obtaining approval for a license.

in recent years with the introduction of stricter regulatory regime. In Cabo Verde, the weak linkage between the domestic and offshore sector should limit risks to the domestic economies.

D. Loss of CBRs in Cabo Verde: Results from Bank Level Survey

10. Cabo Verde has experienced reductions in CBRs since 2013. A survey was conducted by the Central Bank of Cabo Verde in January 2017 with responses from all the seven banks in the country. The survey shows that the terminations are broad based and involve both the central bank and commercial banks. All commercial banks have lost at least one CBR since 2013. The impact on the banking system has so far been minimal but not for individual banks. The second biggest bank in the country lost its US dollar CBRs and now has to rely on the CBRs of other local banks. Banks are also facing increased cost of US dollar transactions.

11. A survey of all commercial banks in Cabo Verde identified two main factors that could explain the withdrawal of CBRs. These are the low volume and value of transaction and perception of AML/CFT risks. The size of the country means that the volume and value of transactions processed by correspondent banks on behalf of their Cabo Verdean counterparts are low, making CBRs a low profit business and therefore less attractive. The views from the banks surveyed were that that CBRs are being withdrawn because the volume of transaction processed by banks in the country did not justify the maintenance of some CBRs. The perception of risk featured prominently in the responses of banks. The presence of an offshore financial sector in the country is likely to heighten the perceived AML/CFT risks.

12. The loss of CBRs has mainly affected US dollar transactions. In terms of currency composition, the terminations mainly involve US dollar transactions but CBRs in euro and other currencies have also been lost. However, some banks reported an increase in the volume of transactions in euro and US dollars processed in 2017.[6] The main products identified by banks to have been affected by the loss of CBRs are international wire transfers, trade finance, and flow of remittances.

13. Banks have tried to replace lost CBRs with smaller, less known specialized and lower rated financial institutions. Other options that could be considered include switching to CBRs in other currencies and relying on other forms of cross border financial services such as letters of credit or trade finance but these options do not particularly address the underlying drivers of CBRs.

E. An Application of the Minimum Scope Monitoring Framework

14. Grolleman and Jutrsa (2017) have developed a framework for CBR monitoring and analysis that could be used by central banks. Their monitoring framework consists of two approaches: the minimum scope framework and the expanded scope framework. The minimum

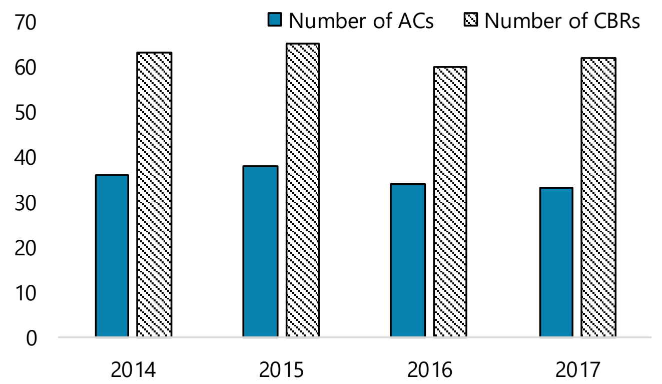
[6] Most USD CBRs are going through Portuguese and Spanish banks and less through global banks like Citibank, BoNY, and Santander+.

scope framework uses accounting data while the expanded scope framework uses SWIFT data for individual payments. The data for the minimum scope framework template are readily available in reporting banks accounting and core banking systems[7]. Due to data availability, this paper applies only the minimum scope framework on data for the Cabo Verdean banking system. Data for the application of the expanded scope framework is not readily available.

15. Several analyses could be conducted within the minimum scope framework. These include, the total number of CBRs and active correspondent banks (ACs)—a correspondent bank with at least one CBR—, developments of volume and value of transactions on a system level, the relative importance of different currencies in the payment flows, currencies in which ACs operate, the relative significance of AC per currency, and the development of CBRs by institution.

16. Number of CBRs. In the minimum scope framework, a first indicator of pressures on CBRs is the number of CBRs. This represents the number of correspondent banks that have provided current accounts to respondent banks and measures the ability of respondent banks to provide their clients with cross border payments. In Cabo Verde, the number of CBRs declined from 65 in 2015 to 62 in 2017 and number of AC also declined from in 38 in 2015 to 33 in 2017. The distinction between CBRs and AC is important for understanding the nature of CBR withdrawal. It helps to determine whether the withdrawals are selective or affecting the overall banking system. The number of ACs is also important in analyzing the degree of concentration of correspondent banking services in the banking system. A high degree of concentration makes the system vulnerable to broad-based withdrawal of a specific AC adding to payment network fragility.

Number of CBRs and ACs

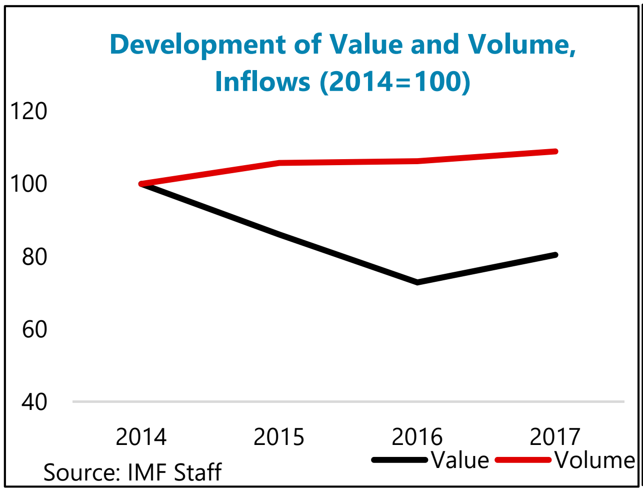


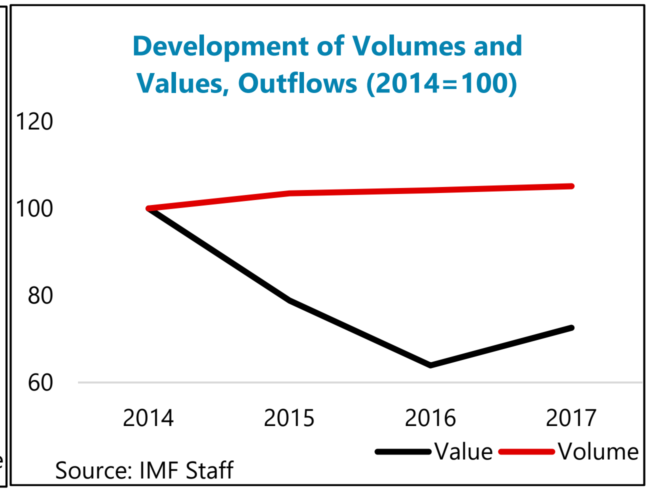
Sources: Central Bank of Cabo Verde; and IMF Staff estimates.

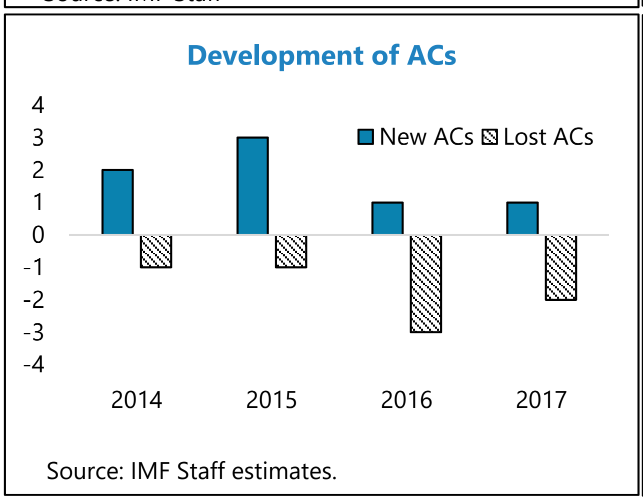
17. Development of value and volume of transaction. One way of measuring the importance of CBRs in Cabo Verde is to examine trends in the number and value of transactions processed through respondent banks in the country. The value of payment flows (both inflows and outflows) declined between 2014 and 2016 before picking up in 2017. While this could reflect CBR pressures, the weak macroeconomic environment during the period may have also contributed to the decline. In contrast, the total volume of payment flows (the number of transactions) has been increasing between 2014 and 2017.

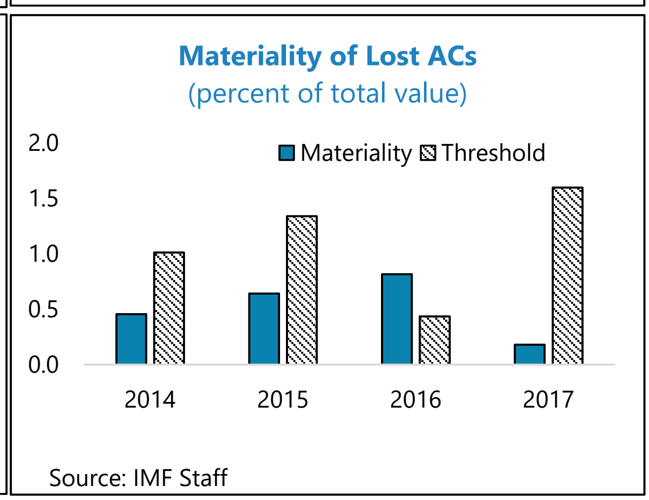
[7] The minimum data needed to effectively use the framework includes the reporting period; the identity and country of the reporting bank and its correspondent bank; the number and identifier of the different current (nostro) accounts provided by the correspondent bank; the currency in which the accounts are denominated; and the total value and volumes of transactions for each reporting period.

18. Development of ACs and materiality of lost ACs. Material ACs are correspondent banks that account for more than a certain share of total payment flows per reporting period. To determine if a loss of an AC is material, a materiality threshold needs to be established. This threshold can be set as a fixed percentage of the total payment flows or as percentage specific to the banking system of the country. This paper uses the system specific approach and set the materiality threshold at 0.4 percent for 2016 and 1.6 percent for 2017. These thresholds correspond to the share of the smallest bank in the payment flows in Cabo Verde. Any withdrawal of a specific AC that account for 1.6 percent of the total flows in 2017 will result in the smallest bank losing all its CBRs. The assumption is that the AC that withdraws is the main correspondent bank of the smallest bank in the country. In 2016, the loss of the 3 ACs were material as they accounted for 0.8 percent of total flows, higher the threshold of 0.4 percent for that reporting period. In 2017, a total of 2 AC withdrew and 1 new AC started operation. The flows handled through these lost ACs were not material.

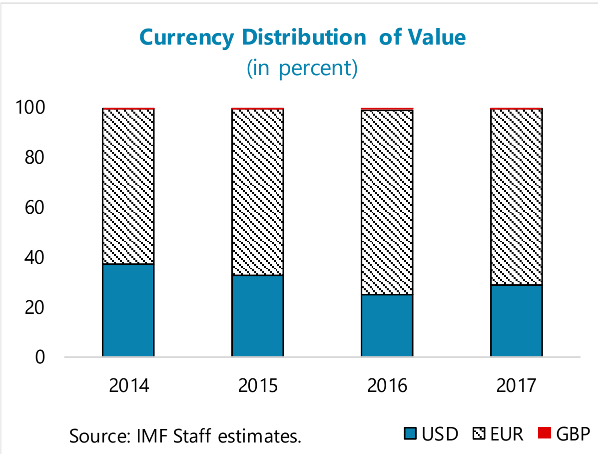


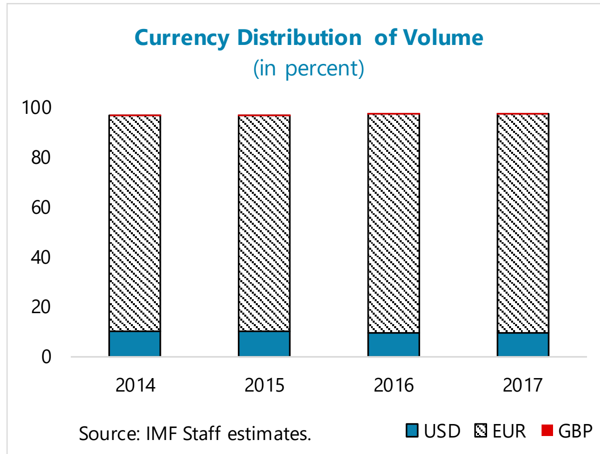




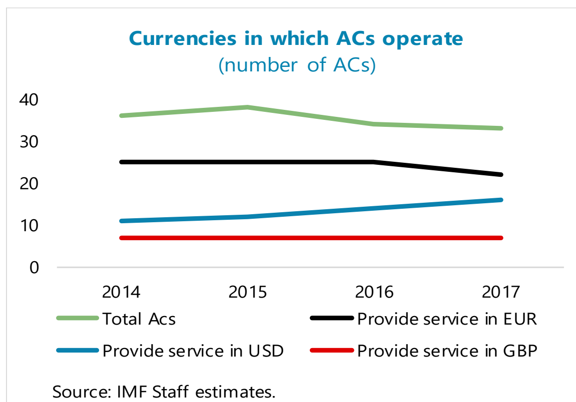


19. The relative importance of different currencies in the payment flow. In Cabo Verde, the analysis shows that the euro dominates the payment flows both in terms of value and volumes accounting for about 68 percent of payment values. It is followed by the US dollar with about 29 percent of payment flows. The composition of the flows has tilted in favor of the euro with the share of the US dollar in the payment flow declining from 37 percent in 2014 indicating some switching between the US dollar and other currencies. The reduced share of US dollar in the payment flow provides an indication of CBR pressures in the banking system. The Increased value of US dollar CBRs in 2017 independent of business cycle effects may reflect some recovery in USD CBRs after the sizeable withdrawal in 2016. The increase may reflect access to increased nested CBRs. In terms of volume, the euro still dominates with about 88 percent of the total volume of payments and the composition has remained very stable.





20. Currencies in which ACs operate. ACs operate in three major currencies in Cabo Verde the euro, the US dollar, and the British pound. Most ACs provide accounts predominately in euros but also provide services in US dollars and to a lesser extent British pound. Given the importance of the euro in the payment flows, 22 of the 33 ACs in the country provide euro services with about 16 ACs providing US dollar services.

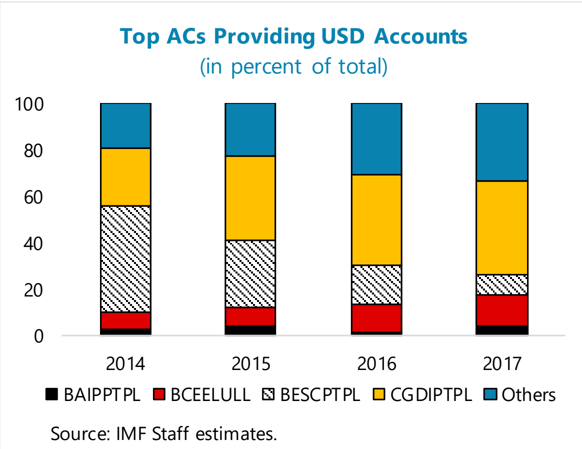


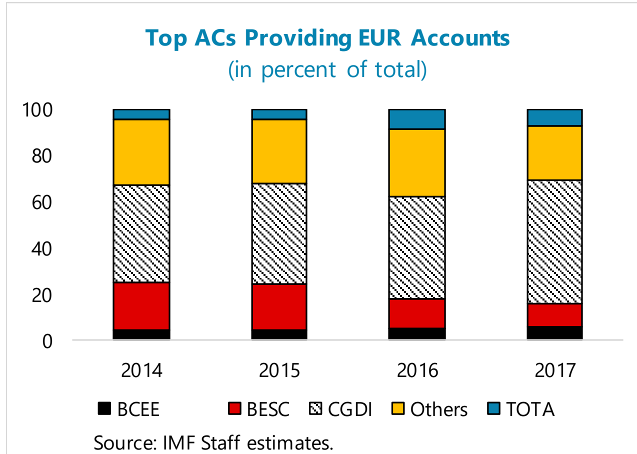
21. The relative significance of ACs per currency. Euro flows are dominated by CGDI (Caixa Geral de Depositos) with about 70 percent of all euro flows. The concentration of euro flows through the top AC, CGDI (Caixa Geral de Depositos) has increased after BESC's (Banco Espirito Santo) resolution in late 2014. In terms of US dollar payments, the flows are dominated by CGDI (Caixa Geral de Depositos) and its share increased after BESC's (Banco Espirito Santo) resolution.

22. Development of CBR by bank in terms of total value of payments. Banks 2 and 6 dominates the payment flow jointly accounting for more than 70 percent of the banking systems cross border payment flows. In particular, Bank 2 is handling the largest share of the cross-border flows accounting for almost half of the systems cross border transactions. The flows the bank handled has remained relatively stable between 2014 and 2017.

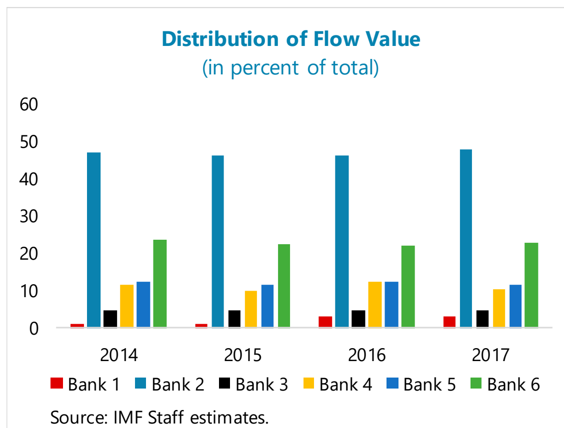
F. Ongoing Policy Initiatives

23. A number of initiatives to address the specific drivers and mitigate the potential macroeconomic impacts are being considered, and some are already being implemented. The focus of the initiatives has been on preventing the withdrawal of CBRs from reaching alarming levels given the muted macroeconomic impact thus far.





24. The Cabo Verdean government has initiated measures to strengthen the AML/CFT framework to help combat the loss of CBRs., Cabo Verde introduced changes to the AML/CFT framework in 2013 and tax evasion legislation to address deficiencies identified by GIABA (Inter-Governmental Action Group Against Money Laundering in West Africa in the 2007 AML/CFT assessment. The government also developed guidelines for real estate agents and casinos to guide professionals in these sectors on how to conduct their business transactions and prevent money laundering. The government relocated the Financial Information Unit (FIU) from the Central Bank of Cabo Verde to the Ministry of Justice and established informal agreements with the FIUs of Ireland and Italy. Despite these steps, more needs to be done to ensure that the FIU is fully functional and has sufficient operational independence. Cabo Verde needs to further address any deficiencies in the ongoing AML/CFT assessment against the revised Financial Action Task Force standards, which will be finalized in late 2018.



25. At the bank level, commercial banks in the country are strengthening compliance frameworks to avoid further loss of CBRs. In a survey of banks, many of them indicated that the volume of in-house compliance work by banks has increased significantly in response to the opening and maintenance of customer accounts and the requirements of correspondent banks associated with international banking transactions.

G. Policy Recommendations

26. Given the multiplicity of drivers, addressing the withdrawal of CBRs in Cabo Verde to prevent potential adverse macroeconomic impacts requires policy initiatives on several fronts:

- **Continue gathering data and monitoring pressures on CBRs**. Drawing on feedback from the private sector (both respondent and correspondent banks), the authorities need to continue to gather data to better understand the nature, scale, and scope of CBR withdrawals, determine the main drivers, and help develop and refine policy guidance. Improvement in statistical analysis of CBR information, including the adoption of the minimum scope framework developed by the Fund would also assist in better understanding and monitoring the phenomenon.

- **Ensure the efficient implementation of AML/CFT regulations.** This would help provide confidence required by correspondent banks. However, it is worth recognizing that this may not be sufficient if withdrawals was due to business strategy or profitability decisions or lack of alignment of AML/CFT systems and processes between correspondent and local banks. It is also important to operationalize the Inter-Ministerial Committee on AML/CFT and adopt a national AML/CFT strategy and address any other deficiencies identified in the ongoing AML/CFT assessment. Implementing the tax good governance standards agreed with the EU will help prevent the country from being labelled a non-cooperative tax jurisdiction. The authorities have already started work on improving cooperation with other jurisdictions on tax issues.

- **Strengthen AML/CFT supervision of banks**. This is necessary in order to ensure the effective implementation of AML/CFT controls by banks, which could contribute to increasing global correspondent bank's trust in Cabo Verde's banks' ability to manage and mitigate their risks

- **Reevaluate the sustainability of high-risk business lines.** To the extent that respondent bank's capacity to manage risks associated with higher-risk businesses (such as offshore) are weak, they may need to consider terminating those businesses or services.

- **Improve domestic risk management capacity and the regulatory environment**. This will require enhancing Cabo Verdean banks' capacity to manage risk. Cabo Verdean banks could request policy statements from their correspondent banks on transactions considered high risk and seek technical assistance where necessary to strengthen their risk management capacity.

- **Improve information sharing and communication between global banks and respondent banks**. This would help foster a mutual understanding of risks and clarify global banks risks tolerance policies.

- **Automate due diligence process.** Automating account documentation, including customer and beneficiary identification information, business correspondence, and account activity, would help improve compliance screening procedures in Cabo Verdean banks. Over the long term, this would help reduce cost associated with implementing due diligence measures expected by global banks.

- **As a long-term solution, explore advances in information technology to reduce costs and improve risk management**. Blockchain providers, for instance, have argued that the distributed ledger technology could help improve correspondent banking by reducing transfer costs, improving transparency and risk management, and reducing settlement periods. While the last two policy measures are useful to consider, they may have more limited impact in the short term.

H. Summary and Conclusion

27. Banks in Cabo Verde have experienced a reduction in CBRs since 2013. Bank level survey shows that the terminations are broad based and involves both the central bank and commercial banks. The impact on the banking system has so far been minimal but banks reported facing increased cost of US dollar transactions. The continued loss of CBRs can affect the Cabo Verdean economy through reduced international trade, migrant deposits, remittances, and investment flows. Given the country's reliance on remittances and migrant deposits, much of the strain is likely to be felt by the remittances sector with possible economic implications.

28. The results using the minimum scope framework shows that value of payment flows declined significantly between 2014 and 2016. While this could reflect CBR pressures, the weak macroeconomic environment during the period may have also contributed to the decline. Flows handled through the lost ACs were not material in all years before the withdrawal except in 2016. Most ACs provide accounts predominately in euros but also provide services in US dollars and to a lesser extent British pound. Examining trends in ACs in Cabo Verde shows that the reduction in CBR is broad-based across the domestic banking system and not limited to specific banks suggesting either a country specific consideration or more fundamental re-assessment of business model.

29. A number of initiatives to address the specific drivers and mitigate the potential macroeconomic impacts are being considered, and some are already being implemented. The focus of the initiatives has been on preventing further withdrawal of CBRs given the minimal macroeconomic impact thus far. At the bank level, commercial banks in the country are strengthening compliance frameworks to avoid further loss of CBRs. Banks have tried to replace lost CBRs with smaller, less known specialized financial institutions.

30. Addressing the withdrawal of CBRs entails policy initiatives in several areas. This includes continued efforts to gather data and monitor pressures on CBRs and to fully understand the drivers; strengthening the AML/CFT framework, including by ensuring compliance with international standards, strengthening AML/CFT supervision; improving the regulatory environment and domestic risk management capacity; improving information sharing and communication between global banks and respondent banks; and automating the due diligence process to help improve the quality and timeliness of information available to correspondent banks. In the longer term exploring advances in information technology to reduce costs and improve risk management. There is a need for coordinated efforts by all relevant stakeholders at the institutional, national, and regional levels to contribute their knowledge and skills to the resolution of the problem.

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