ZEW policy brief

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How the Withdrawal of Global Correspondent Banks Hurts Emerging Europe

Correspondent banks allow local banks in emerging markets to access the international payments system. This helps local banks to make cross-border payments, clear currencies, and provide trade finance. The recent retrenchment of global correspondent banks following the increased costs of financial crime compliance may therefore disrupt international trade. This policy brief shows that the withdrawal of correspondent banks from Emerging Europe has negatively and substantially affected the exports of this region. Exploiting an unexpected change in the U.S. regulator's enforcement of financial crime legislation we compare industry-level bilateral trade flows of countries experiencing a high withdrawal with those that maintain their correspondent bank relationships. We find that the decreased availability of international payment and trade finance services has considerable negative effects on exports. This negative effect is stronger for trading partners that are geographically more distant. A survey of 93 local banks confirms that banks face growing difficulties in performing cross-border payments and in clearing currencies. In particular, access to the U.S. financial system is severely inhibited and local banks can only imperfectly substitute lost correspondent bank relationships with new partners from Russia and Austria.

KEY MESSAGES

- We show that countries with a high withdrawal of correspondent banks have a 6 to 8 percentage point lower growth in exports compared to those that maintain their correspondent bank relationships.
- We relate the withdrawal of correspondent banks to increased due diligence costs and financial crime compliance and show the costly side effects of the important fight against financial crime: while in 2013, only 7 per cent of the banks found it difficult or impossible to access U.S. dollars, this fraction had increased to 26 per cent in 2019.
- In the short run, there appears to be few substitutes to fill the void in cross-border payment and trade finance services. New technologies may provide alternative solutions in the future, but these should be held to equally high regulatory standards to safeguard financial stability.
- Local banks themselves can act by bringing their compliance procedures up to the required international standards and by ensuring that their staff obtain professional certificates, e.g. in customer due diligence, financial crime prevention, and anti-money laundering risks in correspondent banking.
- National governments in Emerging Europe would be advised to expand their export credit guarantee schemes, particularly for small and medium enterprises.

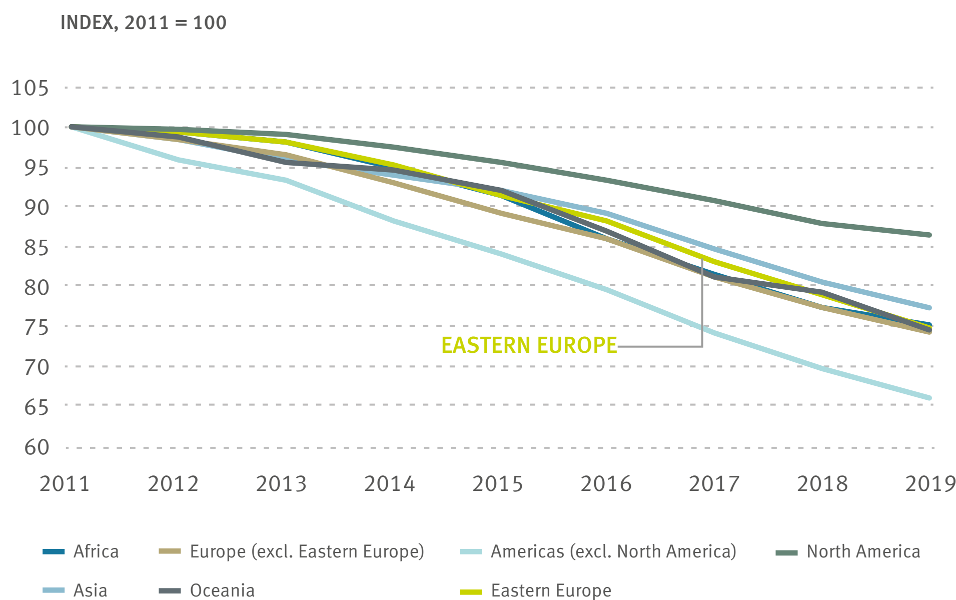
THE IMPORTANCE OF CORRESPONDENT BANKS FOR INTERNATIONAL TRADE

Correspondent banks are essential for international trade

Correspondent banking refers to arrangements where one bank (the correspondent) holds deposits from another bank (the respondent) while providing international payment and other services. Correspondent banking is essential for international trade for at least two reasons. First, correspondent banks enable cross-border trade-related payments from importers to exporters. Specifically, correspondent banks facilitate payments between the exporter's and the importer's local banks, which usually do not hold accounts with each other. Second, correspondent banks also participate in bank-intermediated trade finance solutions, such as letters of credit, which facilitate trade when and where the probability of non-payment or non-shipment is high and enforcement is expensive.

Against this backdrop, it is worrying that firms in many emerging markets have recently experienced a sharp decline in their access to correspondent banking services. Figure 1 shows that the number of active correspondent banks has decreased significantly over the past decade.

FIGURE 1: NUMBER OF ACTIVE CORRESPONDENTS IN EACH REGION (COUNT OF COUNTERPARTIES ABROAD)



Increased costs of financial crime compliance are major driver of a correspondent bank withdrawal

One crucial event that contributed to the withdrawal of correspondent banks is the record $8.9bn fine issued to the French correspondent bank BNP Paribas in June 2014 for violating sanctions against Sudan, Cuba, and Iran, as the bank allowed international transfers from these regions. The ruling made clear that any bank facilitating global transactions that threaten the integrity of the U.S. financial system can, in principle, be tried in front of a U.S. court. The penalty led to a sharp reassessment of the costs of financial crime compliance among correspondent banks – both with respect to the required level of due diligence and expected fines – and contributed to the withdrawal of correspondent banks from countries with a high risk of financial crime.

DECLINE IN CORRESPONDENT BANKING SLOWS EXPORTS

Number of correspondent banks has decreased considerably in Emerging Europe

In a related study, we quantify the real effects of the global retrenchment of correspondent banks. Our analysis focusses on 17 transition economies in the Baltics, Central Eastern Europe, Eastern Europe, South Eastern Europe and the South Caucasus. The region, which we refer to as Emerging Europe for simplicity's sake, is closely integrated with Western Europe in terms of banking systems as well as trade. A reduction in export opportunities in Emerging Europe should therefore impact firms in Western Europe.

The average decline in active correspondent banks between 2011 and 2016 was 14.4 per cent in our sample. While the number of correspondent banks remained stable in some countries (Bulgaria, Czech Republic, Hungary and Slovakia), Latvia faced a 14 per cent decline and Moldova a 56 per cent decline on the back of money laundering concerns. Such concerns were not unfounded, as banks in these two countries ran a vast money-laundering scheme in the 2010 to 2014 period, moving at least $20bn in illicit funds to the U.S. and other countries.

Export growth rates are lower in countries with high correspondent bank withdrawal

We compare export growth during the twelve months before vs. the twelve months after the BNP Paribas court ruling in countries that experienced a high withdrawal of correspondent banks and those that experienced a low withdrawal. We document that industries from countries with a high withdrawal of correspondent banks had export growth rates 6 to 8 percentage points lower than industries from countries with a low withdrawal. This finding suggests that a reduction in the availability of correspondent banking services comes with considerable real costs.

Geographical distance reinforces the negative trade effect

Geographical distance plays an important role in defining information asymmetries and monitoring costs, both in bank–bank and bank–customer relationships. Accordingly, our results show that trade growth decreases more with larger geographical distances between trading partners. Larger geographical distances make it more difficult to maintain and build new correspondent banking relationships, as both credit and financial crime risk are more difficult to assess with greater distance.

NEGATIVE ECONOMIC CONSEQUENCES FOR LOCAL BANKS IN EMERGING EUROPE

Local banks report substantial negative effects from withdrawal of correspondent banks

To further assess the economic consequences of this sharp and sudden drop in the availability of correspondent banking, we conducted a survey among local respondent banks in the EBRD region.[1] The survey took place at the end of 2019 and questions covered the period from 2009 to 2019. Out of the 131 invited banks, 91 banks across 28 countries completed the entire questionnaire, amounting to a response rate of 69 per cent. The survey yields three main insights:

1. Correspondent bank networks have changed over time. While in 2013, 75 per cent of the correspondent banks were based in the U.S. and Germany, these two countries only held a combined share of 54 per cent in 2019. Correspondent banks now hail from a broader variety of countries with an increasing share of Russian and Austrian banks. The replacement of U.S. correspondent banks with those from other regions may be unfavourable to the extent that it leads to longer and hence costlier intermediation chains.
2. Respondent banks reported higher costs and more difficulty in accessing correspondent banking services. Local banks find it particularly difficult to access U.S. dollars. While in 2013, only 7 per cent of the banks found it difficult or impossible to access U.S. dollars, this fraction increased to 26 per cent in 2019. About 10 per cent of the banks stated that access to the U.S. payment system has been severely limited or even completely lost due to the withdrawal of correspondent banks.

[1] EBRD region as defined by the European Bank for Reconstruction and Development; see *https://www.ebrd.com/where-we-are.html*

3. Local banks indicated that the most important reasons for the decline in correspondent banking services were that "correspondent banking relationships do not generate sufficient business to justify the cost of additional customer due diligence" (67 per cent) and that "foreign correspondent banks have terminated relationships as a consequence of the stricter enforcement of anti-money-laundering and combatting-the-financing-of-terrorism regulations" (51 per cent).

These answers confirm that the withdrawal of global correspondent banks from emerging Europe has had considerable negative effects on the region's domestic economies.

WHO COULD FILL THE VOID IN THE LONG RUN?

There are no obvious substitutes in the short run

Our analysis highlights that de-globalization in banking can have substantially negative real effects for firms in emerging markets. While our study only investigated the short-term implications of withdrawal, the effects on trade may be long-lived, even if correspondent banks decide to re-enter certain countries (in part because local knowledge and relationships need to be re-established). While correspondent banks from East Asia and the Pacific Region are growing, they still mainly provide services in domestic currencies and thus cannot make up for reduction in international U.S. dollar and euro transactions.

However, the negative effects on trade could be partially offset by trade insurance products for exporters that shift risk to a counterparty (e.g. as part of a government-backed scheme). While adopting new insurance relationships might increase the cost of export initially, this would allow firms to keep their export business running. With regard to the payment services that global correspondent banks offer, new technologies may provide solutions in the future. Currently, however, Fintechs only play a very small role in the market for trade-related cross-border payments, perhaps due to the high cost of compliance with financial crime regulations. This stands in stark contrast to their large presence in the market for international retail payments by consumers. On the demand side, large firms in particular seem to prefer using the services of their local bank to which they have an established relationship, at least so far. This may change as firms become more digital overall and when reliable and trustworthy Fintech alternatives emerge. However, local banks themselves can act by bringing their compliance procedures up to the required international standards and by ensuring that their staff obtain professional certification, e.g. in customer due diligence, financial crime prevention, and money laundering risks in correspondent banking.

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