TAX JUSTICE NETWORK

Correspondent banking and financial secrecy: The basics

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In a globalised world, individuals and firms need to make payments or transfer funds to people and firms in other countries. Yet their local bank may have no relationship with the foreign bank where a person is trying to send money to. Correspondent banking solves this gap by acting as an intermediate between these two unrelated financial institutions.

Correspondent banking involves one bank (the correspondent, typically a large, global bank) providing services to another bank (the respondent, typically a smaller, local bank without access to international payment systems). In order to facilitate cross-border payments, currency clearing and trade finance such as through letters of credit, the respondent is provided with an account at the correspondent bank. While correspondent banking allows funds to flow to more places, the involvement of many institutions that have only partial information on the originator and final recipient of funds creates secrecy. In turn, this creates additional risk of money laundering and other illicit financial flows, since the correspondent bank cannot directly verify the identity or activities of the respondent bank's customers. A particular risk is "nested" banking, where a respondent bank provides services to other financial institutions (downstream banks) without the correspondent's knowledge, adding a further layer of opacity.

There are a range of regulatory frameworks in place for correspondent banking, aiming in theory at least to address these higher risks. These include performing due diligence on the respondent bank, with a more rigorous approach for banks in jurisdictions judged to be high risk, and ongoing transaction monitoring. But there are many weaknesses in this system.

High-risk jurisdictions

First, there is the reliance on crude and inaccurate risk measures for jurisdictions. These often include the lists of jurisdictions compiled by the European Union, the ‘black and grey’ lists compiled by the Financial Action Task Force (FATF), or simplistic, survey-based measures of perceived ‘corruption’. All of these approaches tend to discriminate disproportionately against lower-income countries in the global South. The overall tendency is to drive a damaging phenomenon of ‘debanking’, in which certain countries have become largely or completely cut off from international financial services – despite typically posing little or no risk.

At the same time, genuinely high risk jurisdictions – those that have been shown consistently to pose a significant global threat of facilitating illicit financial flows

– almost never feature on politically-led and often opaquely constructed institutional lists, or among self-fulfilling measures of corruption perception.

The Financial Secrecy Index provides the leading alternative, with an evaluation of jurisdictions based on transparent and rigorously assessed criteria that capture a wide range of specific features of financial opacity and non-cooperation. For example, the banking secrecy indicator includes key elements of FATF assessments but also goes well beyond to consider regulatory access to banking information, and legislative support for banking secrecy. Across the 20 indicators that generate the overall Secrecy Score, the Financial Secrecy Index provides a robust basis for granular, geographic risk assessment, including at the transaction level.

Customer's customers and beneficial owners

Correspondent banks do not have direct and automatic access to the originator's or beneficiary's beneficial ownership information for all transactions, meaning that they have to rely on those banks with direct contact with customers to do proper customer due diligence and block criminals from opening accounts and transferring funds. Ensuring that each bank is properly obtaining information and preventing the wrong people can open accounts can be especially challenging, when considering the low levels of effective supervision of financial institutions or the low number of countries with publicly accessible beneficial ownership registries, especially since the European Court of Justice ruling.

Conclusion

While regulatory approaches rely on crude and simplistic measures, and due diligence of correspondent banking relationships is high level at best and purely performative at worst, these failures will continue to see lower-income countries and their citizens unfairly excluded from international financial services; while the risks of illicit financial flows will remain high, and concentrated in the major financial centres that are predominantly responsible.

Countries can do a much better job in tackling illicit financial flows, not just by increasing transparency (particularly beneficial ownership data) for every involved financial institution, but also by using transactional data (e.g. SWIFT data) at a national or global level, beyond what any partially-looking bank can do on its own.