"Trends And Challenges In A Changing Global Financial System And Economy"

Address by Camillo Gonsalves to the 14th OECS Credit Union Summit
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[*FORMAL GREETINGS*]

It is an honour to address this the 14th Annual OECS Credit Union Summit, and it is even more so to have you assembled here in Saint Vincent and the Grenadines. The credit union movement, and its member-centred focus on service, equity and cooperation, has been an essential pillar of economic growth and development, here in Saint Vincent and the Grenadines and across the Caribbean. In the OECS, in particular, our unique economic and social characteristics have allowed credit unions to carve a special and indispensible role in meeting the needs and achieving the aspirations of our citizens.

However, the historical role played by credit unions in regional growth and development is now being challenged by new forces – most of them external – that are redefining the global financial system, and reshaping the space that credit unions have traditionally occupied. These forces – spurred by globalization and accelerated by the continuing fallout of 2008 financial and economic collapse – are giving rise to new rules, new threats and new opportunities that are fundamentally altering the playing field and affecting the ways that banks and credit unions do business, to say nothing of the services that customers and members expect of their financial institutions.

Local governments and regional institutions must actively address some of these new forces with a view to mitigating the threats and increasing the opportunities implicit in these rapidly-changing circumstances. However, it is the financial institutions themselves – particularly credit unions – that must take stock of the current realities and fashion ways to survive and thrive in a radically revised environment. Some of the necessary responses to these new realities will undoubtedly involve greater "cooperation, integration and innovation" between and among regional credit unions, which makes the theme of this year's gathering an especially apt *prescription* to a host of modern maladies.

The new trends and challenges are too numerous and wide-ranging to effectively enumerate in a single speech. The main focus of my presentation will be on the existential threat posed by the modern trend of de-risking and loss of correspondent banking

relations in the Caribbean region. But before I discuss that issue, it is worth mentioning a few other issues, each of which is worthy of your deeper exploration and response.

GLOBAL TRENDS & CHALLENGES

The overarching challenge to the global financial system and our regional economies is the continued post-crisis instability and anemic growth in the major economies to which we are most connected. The IMF's most recent *Global Financial Stability Report* was unambiguous in stating that global financial stability risks increased because of higher economic risks and uncertainty, falling commodity prices, and concerns about China's economy. As a result of these developments, financial markets have reacted negatively or with unpredictable volatility. Global equities plummeted; volatility rose sharply; talk of recession in advanced economies increased; and bank equity prices came under renewed pressure. These pressures tightened financial conditions, reduced risk appetite, raised credit risks, and stymied balance sheet repair.

As is now commonplace in the post-crisis global economy, this global instability has a lagging, knock-on effect on the economies in our region. When the major economies of China, Europe or the US sneeze, the OECS catches a cold. When they all sneeze together, as in the present wave of global instability, the regional malaise is manifested in slow growth, weak tourism receipts, reduced remittances, limited foreign direct investment, and a chilling effect on local lending and entrepreneurship. Each of these symptoms have particular repercussions on the ways in which credit unions act in our local context.

Further, the recent decision by the British people to leave the European Union has exacerbated this uncertainty and instability, and will no-doubt continue to have unpredictable consequences as the governments of the United Kingdom and the EU begin their process of disengagement. While it is impossible to reliably predict whether "Brexit" will radically alter the global economic balance or whether the fallout will be a net positive or negative for our region, it seems safe to say that the *process* of disengagement will be fraught with uncertainty. This uncertainty, and the contours of the final arrangements could have major legal and economic implications for the U.K.'s very large financial services industry and for the cross-border financial flows on which the U.K. is highly dependent.

Indeed, the Office of Financial Research of the United States Treasury said that the Brexit vote increased threats to US financial stability. The Treasury Department said that:

> *Overall risks to U.S. financial stability . . . have been pushed higher by the vote in the United Kingdom (U.K.) to exit the European Union (EU). The result surprised financial markets and was a negative shock to investor confidence. It introduces months or years of uncertainty about the rules governing the U.K.'s investment, financing, and*

> *trade relations. Larger shocks to confidence are possible as those deliberations and negotiations play out. Because the U.K. economy and especially the U.K. financial system are highly connected with the rest of Europe and the United States, severe adverse outcomes in the U.K. could pose a risk to U.S. financial stability.*

Again, given the size and openness of our local economies, the risks of contagion to the OECS are high. The process of the UK's disengagement, which will take place over the coming years, is of special interest to our region, given our historical and ongoing relationships in trade, immigration, remittances and tourism.

Technological advances and trends are having a major and disruptive effect on the ways in which regional institutions do business, and the expectations that customers and members have of those institutions. In the OECS, we have achieved a critical mass in terms of Internet access, with most citizens owning devices capable of reliably connecting to reasonably speedy online service. Our region has one of the world's highest penetration rates of mobile phones and smart phones, and our in-home broadband access is steadily increasing. Our increasing access and *comfort* with out new digital connections is creating new pressures on banks and credit unions to allow members to "skip the lines" and do their banking and account management from home, at work or on the go. Credit unions will have to invest heavily in their respective digital presences, and in staying abreast of the evolving regional legislation that governs electronic banking and transactions.

Increasingly, credit unions will distinguish themselves in the ease of use and range of services that are available to members through their digital devices. As members demand and expect access to their accounts "anywhere and anytime," credit unions that are slow to adapt will be the dinosaurs facing a certain extinction delivered by an oncoming technological asteroid. Beyond electronic banking services, your next generation of membership will be purchasing goods and services online using decentralized crypto-currencies like Bitcoin, which hold equal measures of potential and peril for our economies and methods of trade and transactions. The potential of these crypto-currencies to solve many of our current problems – and create new ones – cannot be ignored.

By the same token, the issue of cybercrime is a clear and present danger both globally and regionally. As economies and individuals become increasingly digitally interconnected, cybercriminals are increasingly concentrating their energies on the data and dollars that are accessible through institutions' apps and websites.

Recent cyberattacks on banks in Vietnam and Bangladesh put financial institutions and regulators on edge about weaknesses in the global financial infrastructure, including the Swift global interbank messaging service where breaches occurred.

The Deputy Treasury Secretary of the United States recently said that G-7 economies have to focus on cybercrime "as an issue that goes to financial stability." Hackers and cybercriminals often try to access these financial networks through small banks and credit unions, whose cyberdefense measures are viewed to be less robust than big banks and major financial institutions. As such, the reach and rapidly evolving nature of cybersecurity will demand information sharing and cooperation between financial firms themselves, and a heightened sense of industry-to-industry collaboration, rather than simple reliance on government mandates and far-reaching bureaucratic frameworks.

Credit unions cannot stick their heads in the sand in the face of these game-changing technological advancements, nor can they be technophobic Luddites that fear or attack these new tools and modes of service delivery. However, an ad hoc, uncoordinated approach to emerging and established technological trends will have a negative effect on your business model and membership. Cyber-opportunities and cyber-challenges are issues that demand your collective, coordinated focus.

Other global trends are also critical, from the rising levels of bad loans and the need for improved screenings and clearinghouses of creditworthiness to the regional trend of seeking profit not through traditional lending and investment but on hidden or additional fees for services that were hitherto free, are increasingly crucial to our local and regional realities. Customer service is also a critical component of the current environment, as financial institutions seek to maximize profit through automation of services and centralization of decision-making. The ECCB recently approved what, to my mind, is an unconscionable reduction in banking hours without a simultaneous requirement of increased ATMs or standards of online access to accounts.

The increased callousness and anti-customer profiteering of some regional banks also create special opportunities for the credit union movement to increase its membership through a renewed focus on the member experience.

DE-RISKING and THE LOSS OF CORRESPONDENT BANKING RELATIONS

That rather lengthy preamble and tour through a litany of trends and challenges leads me to the issue of so-called "de-risking" and the loss of correspondent banking relationships – a subject that I consider to be of critical importance not just to regional economies generally but to credit unions in particular. I have no doubt that it is a topic that has already received your focused attention. However, the existential nature of this threat, and its potential to completely disconnect our countries from global finance, is difficult to overstate, and bears constant repetition until both public and private institutions can craft

a coordinated approach to this monumental challenge.

As you are all aware, "de-risking" refers to financial institutions terminating or restricting business relationships with clients, or categories of clients, to avoid rather than manage risk.
De-risking is an offshoot of new anti-money laundering and countering the financing of terrorism (AML/CFT) regulations, as well as so called "Know Your Customer" and other regulatory measures implemented in the wake of the global economic and financial crisis. De-risking has increased significantly in recent years, and the result has been that many banks, businesses and individuals have been denied access to financial services from traditional service providers.

The handmaiden of de-risking is the termination of correspondent banking relationships (CBR). CBRs are essential to enabling companies and individuals to transact internationally and make cross-border payments. Financial institutions in the Caribbean often rely on correspondent banking relationships to provide access to the global financial system and underpin trade finance. As the Caribbean Development Bank recently explained:

> *Correspondent Banking Relationships (CBRs) exist between banks providing financial services (correspondent banks) and banks receiving those services (respondent banks). CBRs are fundamental to the efficient operation and resilience of the global financial system. They facilitate the re-allocation of capital, cross border payment systems and other services which are essential for international trade. CBRs also enable financial inclusion by providing to governments, corporations and ordinary citizens with access to a wide scope of globally networked financial services. In this way, they contribute immensely to the stability of the Caribbean's economic, financial and social ecosystem.*

As major international banks re-assess their exposure to risk and balance the cost of compliance against the profitability of their relationships with other institutions, a wave of CBR terminations has hit the Caribbean. Indeed, according to the World Bank, the Caribbean is the region "most severely affected" by the termination of CBRs as a result of de-risking. According to a November 2015 study by the World Bank, "*89 percent of [Caribbean] jurisdictions reported experiencing significant to moderate declines in their foreign CBRs. Of the 19 respondent authorities, 15 reported significant declines and two others noted a trend towards decline or a moderate decline*."

The Caribbean Development Bank is more explicit in its chronicling of this trend:

> *Economically, the impact of the continued decline in correspondent banking on the Region has been substantial. Direct financial sector impacts include reduced business*

by banks and other financial intermediaries. For example, in Barbados, eight financial institutions have had their CBRs severed. Five of seven banks in Belize have had their CBRs terminated. In the Bahamas, two domestic banks and four international banks have also had their relationships brought to an end. In Haiti, all local banks have had their access to correspondent banking either severed or reduced. In the Eastern Caribbean Currency Union (ECCU), local banks that have maintained CBRs now have to pay significantly higher fees. Money Service Businesses (MSBs) such as, cambios in the case of Jamaicaand money transfer services (Bahamas, Cayman Islands, Turks and Caicos Islands) have also been significantly impacted. In July 2015, Western Union closed its operations in the Bahamas and Cayman Islands.

Antigua and Barbuda is currently experiencing serious challenges with maintaining correspondent banking relationships, as in Montserrat. Elsewhere in the Eastern Caribbean Currency Union, local banks that have maintained CBRs now have to pay significantly higher fees.

A study by the Commonwealth Secretariat explained how de-risking and loss of CBRs has already affected our CARICOM neighbor Belize:

[A]lmost all banks operating in the country have been a affected by CBR closures or restrictions since Q4 2014, significantly impairing the ability of Belizean individuals and businesses to transact and trade internationally.

In 2016, two Belize banks lost their credit card settlement accounts in the USA. At the time of writing, these banks were unable to settle their credit card balances with payment systems operators, such as Visa, which insist on their customers using US bank accounts. These closures have had significant implications for the tourism industry in Belize as well as other international businesses operating from the country.

According to a recent Moody's Investors Service report (2016), '80% of Belize's banking system is likely to lose correspondent and credit card settlement services by mid-year 2016', with the loss of these services potentially disastrous for the country . . . Furthermore, if this trend continues, it could place significant pressure on central bank reserves, leading to potential credit default.

De-risking poses a serious threat not only to the banking and financial systems of Belize, but also to the operations of its monetary authority. The Central Bank of Belize lost one of its overseas accounts with a major international bank in 2016, impairing the country's ability to manage its official foreign exchange reserves, which are

essential for ensuring foreign currency liquidity and absorbing external shocks in times of crisis.

The Prime Minister of Belize has spent an inordinate amount of his time personally visiting banks and US regulators, begging them to take his country's money. [Imagine a hotel where tourists are making reservations with credit cards, or any other business relying on credit card purchases. Imagine someone trying to wire money from their bank account to a family member's. Imagine a government trying to issue a letter of credit to a foreign investor.] And remember that we are at the ***beginning*** of this trend in the region. The worst is likely yet to come.

It is important to note that this de-risking and accompanying termination of CBRs in the Caribbean has generally **not** been as a result of our institutions running afoul of anti-money laundering or terrorist financing regulations. Indeed, our region's financial institutions are generally well regulated. However, many large international banks consider their business with the region as either high risk or unprofitable. With risk appetites declining in the wake of the 2008 global crisis, many financial institutions have opted to exit relationships assessed as being high risk, unprofitable, or simply "complex," such as those with money service businesses (MSBs), foreign embassies, international charities, and correspondent banks. These financial institutions now have to maintain massive regulatory compliance departments that scrutinize every transaction to avoid massive penalties and fines. When they balance the cost of compliance against the small size and volume of transactions from relatively tiny banks, it is often cheaper – and certainly less risky – for the large institutions to simply terminate their relationship: no matter how well-regulated the local bank may be.

DE-RISKING AND CREDIT UNIONS

The de-risking trend poses particular challenges to credit unions, particularly OECS credit unions, for a variety of interrelated reasons. In the United States, American credit unions have been particularly hard hit by termination of CBRs. In 2013, 30 credit unions in West Virginia and Ohio were forced to scramble to establish new correspondent vendors after a regional and national bank terminated their accounts. These credit unions, with asset bases in the billions of dollars, were deemed too small and risky to continue long-established banking relationships.

The de-risking of larger US credit unions is more than a cautionary tale in our Caribbean context. Allan Wright, an economist with the Inter-American Development Bank noted that de-risking by regional branches of international banks in the Caribbean has led to termination of "*services to credit unions or building associations, or third-party transactions on behalf of lawyers and other service providers*." The trend of Caribbean credit unions being

shut out by regional and international banks is expected to accelerate in the short term. The truth is that the relatively small asset bases and limited membership of many credit unions – no matter how well managed or regulated – make them easy to shed by correspondent banks. It is oftentimes more cost-efficient to shed a relationship with a small credit union than to hire the compliance staff needed to track their transactions.

Credit unions that send or receive foreign money transfers, that have significant memberships in the US and UK diasporas, or that have relationships with money service businesses are at particular risk from the de-risking trend.

DE-RISKING VS "RE-RISKING" IN THE CREDIT UNION SPACE

In addition to the inherent risks of smallness and relative insignificance to larger banks, credit unions face an additional regulatory threat from de-risking and termination of CBRs. As potentially risky individuals are having their accounts terminated at major financial institutions, these customers are flocking to smaller banks and credit unions that may lack the capacity to deal with these higher-risk customers. A 2015 report by the Global Center on Cooperative Security correctly recognized that the de-risking movement does not eliminate the risk, it merely shifts it. The report quotes a top banking official, who says that "*the ironic result of de-risking is re-risking: you are sending them to banks that probably can't handle it*."

Apart from the simply risky customers who are opening accounts at credit unions, there is the very real likelihood that actual bad actors are also migrating to credit unions – either as a result of or in anticipation of de-risking – because they anticipate that your institutions are less equipped to detect them. This proliferation of risky or improper members at the doors of local credit unions poses special systemic threats and, more narrowly, raises serious questions about the business models, management and regulatory oversight of local credit unions.

Of course, if credit unions become the bank of last resort to the risky castaways of larger regional financial institutions, the demands to bolter your internal regulatory frameworks will be great, and costly. This is not a theoretical concern. Already, a number of reports are documenting the migration of higher-risk customers from less risk-averse institutions to small banks and credit unions. Gatherings such as these must consider not only the desirability of accepting these new members, but also the public relations counteroffensive that you will no doubt have to launch to combat any possible perception that may arise of Caribbean credit unions as a haven for financial undesirables.

Ladies and Gentlemen,

In sum, the de-risking trend in the Caribbean is gathering momentum. It is fueled not by any demonstrated regulatory shortcoming, but rather by perceptions of the Caribbean financial sector as under-regulated, high-risk, and home to money launderers and other criminals. These stereotypes, coupled with our relative insignificance to the bottom line of big banks, is causing these large institutions to shed their "good" customers in an effort to reduce the bank's overall risk profile, even if the business line or customer is or was otherwise profitable. This de-risking leads to the termination of correspondent banking relationships. Credit unions are not only affected institutionally, as they lose ongoing relationships with regional and international banks, but individually, as risky and potentially illicit customers migrate to their accounts.

The answers to the challenge posed by de-risking are multifaceted. Caribbean governments have an important advocacy role, to lobby international bodies like the Financial Action Task Force, the G-20 and the Bretton Woods Institutions, as well as individual regulators in major finance centres. Local financial institutions – including credit unions – must in turn persuade their governments to tackle this advocacy role with the urgency and gusto that it demands.

Measures must be taken across the board to increase confidence in Caribbean banking procedures and regulatory strength. These measures must encourage re-engagement of the international banking sector through changes to national oversight and regulatory guidance.

Given the special vulnerability of credit unions, your importance to our local economies, and in light of the theme of this Summit, your organisations have special responsibilities and considerations. One will be the introduction and adoption of robust best practice standards to combat the unfounded perceptions of credit unions as risks to big banks. This will increase the legitimacy and reputation of the sector – again, not because of any demonstrated shortcomings, but merely as a preemptive response to a jittery international system.

Additionally, in addition to the watchwords of "Co-operation, Integration and Innovation," you must consider the word "amalgamation." There are many advantages to smallness and nimbleness, but in the face of this current de-risking trend, size matters. Just as the phrase "to big to fail" has become part of the post-financial crisis lexicon, so too must "to big to ignore" play a role in risk assessment. It is plainly more difficult to shed a large credit union with large deposits than it is to jettison a tiny one. Credit unions must therefore consider

size and coordination not simply in terms of profitability, but in terms of connectivity to the regional and international financial system.

The de-risking of legitimate credit unions and respondent banks not only affects the discarded institutions and their customers, but can also have profound adverse effects for the stability and safety of the financial system as a whole – thereby undermining the very objectives of these regulations. The extraordinary vulnerability of the Caribbean to this regulatory overreach and cold-blooded termination of CBRs requires a special, sustained, multifaceted and coordinated response. Your credit unions, your movement, can and must be central to this assault on our economic strength and stability.

I thank you for your kind attention.