IS DE-RISKING ONE OF THE INDICATIONS FOR AN EMERGING COMPETITION BETWEEN THE FREE MOVEMENT OF CAPITAL AND THE ANTI-MONEY LAUNDERING REGULATIONS?

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Abstract: *The report is dedicated to analysing the phenomenon of de-risking which may be considered as another indication for the arising competition between the regulatory effect of the anti-money laundering regulation and the deregulatory effect of the liberalization of capital movements within the European Union. The author's attention is focused on the triggering events for both liberalization of capital movements and de-risking, definition of the phenomenon de-risking and its impact on the free movement of capital and payments.*

Keywords: anti-money laundering, free movement of capital, de-risking, financial institutions

1. The rationale behind the liberalization of capital movements

The idea underpinning what is now Article 63 of the Treaty of Functioning of European Union (TFEU) was that limitations on capital must be eliminated in order to allow capital flows to be where they could be it could be invested in the best way possible [1]. The liberalization of capital movements is an evolutionary process started with the understanding that free trade can ensure the economic progress of the Member States. Full liberalization of capital movements was seen also as an essential prerequisite for the completion of the internal market [2], which is considered to be the cornerstone of the European integration. The well-known economist Willem Mole summarised the benefits of the integrated capital markets as follows [3]:

- Reducing the risk of turmoil which can occur in small markets.
- Increasing the amount of capital supplied due to the better investment, which

can result in accumulating more resources.

- Facilitating the accumulation of considerable capitals in the most effective way.
- Providing fair environment and this way reducing distortion in the field of competition.

The original provisions of capital movements were unique in both aspects – firstly, having boarder territorial scope than the other freedoms including flows of capital not only between Member States but also via third countries and secondly, their lack of direct effect [4].

Furthermore, free capital mobility was seen as a prerequisite of the Economic and Monetary Union (EMU). EMU gave renewed impulse to the liberalization of capital flows [5] showing the relation between monetary policy and free movement of capital particularly regarding exchange rates. [6].

For that reason, looking from our point of view it is not a surprise that crucial

advancement in the evolution of the free movement of capital and payments was achieved by the Maastricht treaty, which set the ground for the economic and monetary union, the single currency, and the criteria for its use and admittedly there is strong interconnection between the policy and the 4th freedom of the internal market. This is why an amendment in the provision regarding free movement of capital was required. By the adoption of the Maastricht treaty the free movement obtained the same grade of integration as the other freedoms [7].

At present, the freedom of capital movements is determined by Article 63(1) of the TFEU providing that “within the framework of this provision set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited”. As with the other freedoms, the forbiddance of limitations on the free movement of capital is not complete, and Article 65 of the TFEU provides two express derogations – a general one, concerning requirements of public interest [8] and a specific one, related to taxation [9].

2. The rationale behind the anti-money laundering regulation

Nevertheless, the free trade and the liberalization of capital flows are seen as a factor fostering the illicit activity of criminal organisations giving them possibility to insert in the world’s financial system “dirty money” from their crimes and to use financial institutions to launder their earnings.

Bulgarian author Georgi Petrunov recognizes that due to the liberalized capital movements it is possible to transfer money from one country to another with the little or no obstacles. Huge amounts of money move freely and quickly across countries in search of the most favourable place and the highest level of return, which not only favours the development of business, but also facilitates criminals who seek to

launder their dirty money [10].

Another Bulgarian researcher, Nikolay Aldimirov, notes that with the opening of the borders, the issue of the free movement of goods, persons and capital became particularly important. Through free trade, especially within the European Union (EU) and the enormous flows of goods, which cannot be fully supervised, the laundered money is flowing into the economy. It is through free trade and free movement across the border that more opportunities are opened for organised criminal structures [11].

Finding out that credit and financial institutions are used for money laundering, which is caused by criminal activities, adding to this - the controversial soundness and stability of the institutions concerned [12], the EU took decisive actions against money laundering.

Nowadays financial operators in the single market of the EU are subject of increased regulatory scrutiny and requirements. Obligated entities shall perform risk assessment of their business relationships and customer due diligence, gather information for the beneficial ownership of their customers, perform ongoing monitoring of clients and initiate Politically Exposed Person (PEP) screening, which is resulting in higher compliance cost and administrative burden.

According to a 2014 KPMG survey there is a 53% increase in anti-money laundering costs since 2011 [13]. A 2017 study showed that the real cost of AML compliance across financial institutions in France, Germany, Italy, Switzerland, and the Netherlands is estimated at \$83.5 billion annually [14]. The costs for the five countries are as follows: France - \$21.3 million, Germany - \$21.3, Italy - \$20.3 million, Switzerland - \$17.2 million, the Netherlands – \$17.5. The study summarises that as continuing to evolve, the AML compliance is additional heavy burden on banks and financial institutions due to the threat of large fines and reputational risks in case of violation.

The European anti-money laundering directives emphasize on the risk-based approach [15]. It provides certain freedom to the obliged entities, to manage their activity following their own risk assessment of their customer relationships, but at the same time financial operators are exposed to unspecified and large fines for not complying with the rules. The Financial and Capital Market Commission imposed a fine on Signet Bank of Latvia in the amount of € 906 610 for regulatory requirements violation [16]. SEB bank was fined by The Swedish Financial Supervisory Authority \$107 million for not providing the required AML standards at its subsidiaries [17]. Swedbank was fined with a record fine of \$ 386 million for serious deficiencies in its AML work [18]. These examples give us only a general view of the sanctions warning EU banks and financial operators in the event of non-compliance with the AML regulations.

3. What is de-risking and what its effects are?

“Business relationships or transactions involving high-risk third countries should be limited when significant weaknesses in combating the financing of terrorism (AML/CFT) regime of third countries concerned are identified unless adequate additional mitigating measures or countermeasures are applied. When dealing with such cases of high-risk and with such business relationships or transactions, Member States should require obliged entities to apply enhanced customer due diligence measures to manage and mitigate those risks” [19]. As a result of the increased compliance requirements financial institutions are de-risking from certain markets, services, and clients.

According to the Financial Action Task Force (FATF) “de-risking refers to the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk in

line with the FATF’s risk-based approach” [20]. De-risking is also a strategy implemented by those organisations that cannot manage their money-laundering risks and prefer to cut off relations with institutions or customers they see as risky [21]. Some experts such as Tracey Durner and Liat Shetret identify de-risking as a situation in which “financial institutions exit relationships with and close—the accounts of clients considered a high-risk” [22]. In a 2015 report of the World Bank Group De-risking is determined also as “acting to avoid the risk of non-compliance through reducing potentially high-risk business lines, lower return activities, business with increased regulatory requirements, and others that may expose the sector to undue reputational risk” [23]. The Association of Supervisors of Banks of the Americas describes it as “decision taken by firms to refuse, or to terminate, business relationship with some categories of customers that they associate with higher AML/CFT risk” [24]. The European Banking Authority (EBA) identifies the phenomenon as “decision taken by firms to refuse, or to terminate, business relationship with some categories of customers that they associate with higher ML/TF risk” [25].

According to the FATF, it is misconception to perceive de-risking only as an AML issue. It can be the outcome of different factors such as reputational risk, profitability or other compliance requirements [26].

But in the same time another study conducted for the United Kingdom’s Financial Conduct Authority states that “the process of de-risking has been attributed to the increasing overall cost of complying with regulatory requirements. These include prudential and conduct obligations and, standards as well as the threat of enforcement action for failing to meet such obligations, particularly in relation to AML/CFT”. However, the researchers admit that “there appear to be other factors at play too, including ethical, reputational

and commercial considerations” [27].

Meanwhile a 2016 study of the International Chamber of Commerce revealed that AML and Know Your Client (KYC) issues are seen by 90% of survey respondents “to be impeding the underwriting of trade finance business, while also adversely complicating the processing of that business at national level” [28]. Within the 2020 survey banks again see AML/KYC requirements as the biggest obstacles to future trade and finance growth. [29].

Having in mind that de-risking is real follows the question what its impact on the financial system is? From the FATF point of view the issue is of crucial importance because “de-risking can introduce risk and opacity into the global financial system, as the termination of account relationships has the potential to force entities, and persons into less regulated or unregulated channels. Moving funds through regulated, traceable channels facilitates the implementation of AML/CFT measures” [30].

The World Bank Group sees the following risks, related to de-risking practices [31]:

- Neutralizing of the results achieved in terms of financial exclusion and reduction of payments fees.
- Loss of access to financial services for humanitarian organizations.
- Redirecting high-risk transactions to informal financial services is related with higher AML risk and hinders the process of monitoring suspicious operations.

In its Call for input on “de-risking” and its impact on access to financial services the EBA stated that there are an “anecdotal evidences” that across the EU Correspondent Banking Relationships (CBRs) are terminated due to the higher risk related to them. It is noted that “some segments of the financial sector (e.g., payment institutions and electronic money institutions) have seen their access to banking facilities restricted” [32].

To establish the extent of de-risking within the EU, the EBA gathered information from

competent authorities (CA) as part of the questionnaire prepared for the purposes for its Opinion on ground of Article 6 of Directive (EU) 2015/849 of the European Parliament and the Council of 20 May 2015 [33].

With regards to the responses received through the EBA’s questionnaire, 18 CAs from 18 Member States, mostly responsible for the AML/CFT supervision financial institutions, indicated that they had identified de-risking practices in their jurisdiction. By contrast, 19 CAs from 15 Member States, most of which performing supervision of life insurance entities/life insurance intermediaries reported that they have not observed such practices in their Member State [34].

Responses to the EBA’s Call for Input suggest that financial institutions “are influenced in their decision, from an AML/CFT perspective, by the following key factors” [35]:

- The increased level of geographical risk associated with the business relationships. entities prefer to de-risk a customer that has links with jurisdictions that are exposed to high ML/TF risk.
- The level of risk associated with the nature of the customer. For example PEPs or legal entities involving complex ownership structures that impede the identification of the ultimate beneficial owner.
- The increased level of risk associated with the customer business. Entities prefer to de-risk corporate customers whose business involves processing significant volumes of cash transactions or whose products allow for anonymity. Most affected by this are payments institutions, e-money issuers, real estate companies and regulated Fin Tech companies.
- The high level of risk linked to CBR if there are concerns that the respondent is exposed to significant or very significant ML/TF risks.

Many respondents affected by de-risking indicate that in order to get access to financial services, they had to use alternative channels

including informal funds transfer systems or financial services firms in other EU Member States and in some cases, in non-EU countries. As regard the latter, several respondent banks in need of clearing services through the correspondent banking relationship report that they have sought, as an alternative, correspondent relationships with institutions located outside the EU and therefore outside of the scope of EU supervision.

Considering the above, it is evident that de-risking may have far-reaching implications on the de-risk customers.

4. De-risking as a sign of competition between the free movement of capital and the AML regulations

There is no doubt ML/TF risks could result in have significant negative impact on the financial sector and respectively on the internal market. At the same time, the EU and the Member States also require capital and payments to flow in the most efficient and competitive way possible, because this is considered as a precondition of the desired economic growth.

The concept for the competition between the free movement of capital and the AML regulations is not a new one –Geoffrey W. Smith examined the aspects of this collision in his comment “Competition in the European financial services industry: the free movement of capital versus the regulation of money-laundering”, recalling that the main aim of the economic union is to establish a area of free competition through Europe. The author reminds that the EU “must be wary that in approaching the goal of a common market it does not do away with restrictive maze of national regulation merely to erect in its place a new labyrinth of pan-European regulation” [36]. The new labyrinth of AML regulation is a fact nowadays. Having in mind, the financial institutions are the blood vessels

of the economy, transporting the capital flow there where they are needed, it is easy to understand why regulators share the understanding that it is impossible to combat money-laundering without the cooperation of the credit and financial institutions, and moreover using them as a first line of defence, and respectively imposing new obligations for those institutions. Estimating that globally laundered money is between 2% and 5% of the world gross domestic product, there is no surprise that AML gained unprecedented amount of attention. Additionally, severe fines imposed by regulators are common, resulting that financial institutions all over the world are exiting entire services, customers and markets trying to avoid potential financial and reputational damage related to non-compliance.

In conclusion, number of studies, both globally and a European level, showed that de-risking is a fact, and it has large negative consequences such as of purely AML considerations like forcing persons and entities to turn to shadow financial operators, creating even more risk for the banking system. Another implication is the financial exclusion of vulnerable low-income populations in third countries, many of whom rely on money services business for their banking needs and who could find themselves without access to financial services [37]. Beside the aforementioned considerations it shall be noted that while one of the main advantages of the liberalised capital market is financial services to be delivered internationally in the most efficient way, de-risking is actually threatening to neutralise the effect of that competitive advantage and could be considered as one of the signs of the deterrent effect on the EU's competitiveness generated by the free movement of capital.

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