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De-Risking: Between Money Paradise and Institutional Blast.

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List of Acronyms

AML	Anti-Money Laundering
BIS	Bank of International Settlements
CBS	Consolidated Banking Statistics
CFT	Counter-Financing of Terrorism
FATF	Financial Action Task Force
OECD	Organization for Economic Cooperation and Development
OFC	Off-Shore Financial Centre
SIDS	Small Island Developing State
SME	Small and Medium-Sized Enterprise
SWIFT	Society for Worldwide Interbank Financial Communication

To my mother, to take the risks that matter in life.

Abstract

This Research Paper analyses the developmental issue of financial de-risking within the framework of Small Island Developing States (SIDS) in the Caribbean. The concepts of economic vulnerability as well as resilience are introduced. This is because the main argument of this Research Paper is that the rise of Anti-Money Laundering (AML) and Counter-Financing of Terrorism (CFT) regulations, within the developed economies of the world, has prompted global Financial Institutions to cut or significantly reduced business and financial services' provision to most of the SIDS in the Caribbean. Such phenomenon is increasingly known as financial de-risking. This Research Paper also empirically tests the existence of financial de-risking in the Caribbean by means and measurement of decreasing corresponding banking relationships through declining SWIFT inter-banking messages as well as the net risk transfers that major North American Financial Institutions use as means of guarantees and protection against doing business in the Caribbean. The effects of financial de-risking are analysed in-depth. As such, a case-study is also brought to the analysis whereby the Cayman Islands present a paradox of being a leading Off-Shore Financial Centre (OFC) provisioning niche financial services to wealthy and multinational clients while also suffering from decreased financial and capital accessibility for its local population as well as Small and Medium-Sized Businesses. This Research Paper finalizes with relevant conclusions. It also proposes further policy inquiries by the use of Distributed Ledger Technologies in order to prevent massive risk-averseness by major Financial Institutions as well as to have open communications with financial regulators.

Relevance to Development Studies

This Research Paper introduces the issue of financial de-risking within a Small Island Developing State (SIDS) framework. It adds value to the current and few academic literature on the socio-economic issues brought by both financial de-risking prompted by the rise of Anti-Money Laundering (AML) and Counter-Financing of Terrorism (CFT) measures impacting the SIDS, and in specific the ones situated in the Caribbean. This research project proposes innovative manners of inquiry on the financial de-risking issue by means of analysing the net risk transfer of major North American Financial Institutions in relation to its Caribbean counter-parties. This research also continues with the recent academic legacy of putting into inquiry the decline of correspondent banking in the developing world. In a few words, financial de-risking in the Caribbean diminishes the possibilities for financial and capital accessibility, prosperity and sustainable economic growth given the already highly volatile and vulnerable economies of the Caribbean.

Keywords

Financial de-risking, Small Island Developing States (SIDS), Caribbean economies, financial compliance and regulation.

CHAPTER 1: INTRODUCTION.

September 2018 was a month engulfed by money laundering scandals in Western Europe. ING Bank, the largest bank in the Netherlands and one of the thirty Global Systemically Important Banks, was charged EUR 775 million in fines due to money laundering accusations (Arnold, 2018). Following suit, Danske Bank was also trapped in allegations of financial misbehaving. This would be considered one of the worst money laundering cases in recent times by enabling its Estonian branch to settle as much as EUR 200 billion on illegal financial flows (Milne, 2018). Top management heads were cut and the reputation of both banks was greatly damaged. What is more relevant, September 2018 re-opened the door of popular, political and academic debates on how transparent and compliant are the financial institutions that set the pace of the world´s economic growth.

The banking and governmental regulation on money laundering and terrorist financing took a step forward in the aftermath of the terrorist attacks of September, 2001. In this context, the Financial Action Task Force (FATF) took a leading role in providing with *"Recommendations"* and resolutions for the prevention of money laundering and terrorist financing (FATF 2001 and FATF 2003). The FATF´s *Forty Recommendations* on Anti-Money Laundering (AML) and Counter-Financing of Terrorism (CFT) became the leading polity-basis for both governments and financial institutions within the OECD framework.

With the debatable increase on financial regulation and accountability for financial flows and settlement, it is certain that compliance costs for the world´s major financial institutions have considerably increased in the last years

(English and Hammond 2018). In this sense, the banking race to gain more control over emerging markets seems to be shadowed by more stringent and reaching regulations over where and why the money is flowing (FitzGerald 2004; Tsingou 2010; Truman and Reuter 2004). In fact, the great majority of Western and consolidated banks appeared to be moving away from jurisdictions that pose institutional and compliance concerns in unpredictable manners (Campbell-Verduyn 2018; FitzGerald 2004). In other words, such mutation of financial and corporate interests towards more extensive risk assessments and prudency on investments is a by-product of the infamous risk-based approach proposed throughout the forty recommendations of the FATF and embedded in the mechanisms of Customer Due Diligence (CDD) (Campbell-Verduyn 2018).

Given the increased political and social pressure on the relationship that banks have with their clients, their money and its origin; these factors are playing a crucial part on the phenomenon known as financial de-risking (Campbell-Verduyn 2018; Durner and Shetret 2015; International Monetary Fund 2016; Starnes et al. 2017). In simple terms, financial de-risking explains the institutional aversion in doing business with non-compliant or poorly regulated jurisdictions (Durner and Shetret 2015). Banks from the major financial centres are, therefore, exiting and/or terminating relationships with local and regional financial institutions embedded in a jurisdiction perceived as "risky" or non-compliant with international AML/CFT standards (Durner and Shetret 2015; Starnes et al. 2017). As such, no other type of financial relationship exemplifies the de-risking phenomenon better as the demise of correspondent banking interactions.

Correspondent banking is the provision of financial services, usually by a major financial institution on behalf of a smaller one in a different jurisdiction.

It eases the transmission of business transactions, deposits, financial documentation and other wire transfers (International Monetary Fund 2016; Starnes et al. 2017; The World Bank 2015). Correspondent banking relationships are especially relevant in emerging and developing economies given the fact that they provide with immediate access to the world´s major financial centres and markets (Starnes et al. 2017). However, de-risking has developed into either a rapid decrease or a full stop on correspondent banking relationships. Something that is specifically relatable in the context of Small Island Developing States (SIDS) in the Caribbean (Schmid 2015; Starnes et al. 2017). Now, less are the possibilities for small and medium size enterprises as well as individuals residing in several of the Caribbean islands to finance local development and conduct financial transfers with the rest of the world (Schmid 2015; Starnes et al. 2017; The World Bank 2015). Inevitable, the above described financial phenomenon causes concern at the institutional and political level.

Ironically, some of the selected jurisdictions in the Caribbean had been or are still synonyms of "tax heavens" relying on the provision of off-shore financial services that welcome the wealth originated in developed markets (Cobham, Jansky and Meinzer 2015; von Peter 2007). Consequently, it is pertinent to analyse the current financial and political flows that set the pace of development in some of the economies in the Caribbean. This is not only with the purpose to gain a deeper understanding of the sometimes intrinsically complicated global correspondent banking interactions. But, at the same time, to move forward with the discussion around regulatory compliance in the context of AML/CFT and off-shore banking. Probably, the real issue lies on the grounds of the seemingly well-behaved and compliant developed markets that rely on the securitisation and non-taxation of their wealth by means of off-shore jurisdictions. Nevertheless, the ones affected are exactly the residents of off-shore financial centres and other volatile small economies that find it increasingly more challenging to have access to financing and to global markets by arguments of de-risking.

If the search for transparency and risk-aversion from the part of the major financial institutions is asserted. Then, technology could play an unprecedented role in the upcoming years by diminishing the de-risking rhetoric while enhancing financial and AML/CFT compliance from both developed and emerging markets (Arner, Barberis and Buckley 2017; Starnes et al. 2017). Distributed Ledger applications, usually in the form of blockchain, are being implemented by the most important financial institutions of the world with the hope of developing a more efficient system of compliance and communication between banks and regulators. At the time of writing, the success of the above mentioned technologies remains an enigma. Nonetheless, the dynamics behind the functioning of the Distributed Ledger technologies applied to Customer Due Diligence (CDD) and other compliance as well as transaction tracking processes shed light on the relevancy of financial innovation. Such developments are particularly pertinent at a time whereby the global financial system seems to be too conservative, unethical and unfair towards smaller developing and emerging markets.

RESEARCH QUESTIONS AND METHODOLOGY.

The proposed research paper will rely on four main chapters in order to answer three relevant research questions. The first one is going to inquire on how the decline of correspondent banking relationships between Western financial institutions with the Caribbean is a politico-economic reflection of the rise of institutionalized financial compliance around the globe. Through this light, the geographical focus will be on selected jurisdictions in the Caribbean that belong to the academic framework of Small Island Developing States (SIDS). This is not only because empirical data has been made available in recent years in regards to this area of the world (Arner, Barberis and Buckley 2017; Schmid 2015; Starnes et. al 2017). But it is also a pertinent point of concentration given its research linkage with the second inquiry to be presented in this paper. That is, how the provision of off-shore financial services in the Small Island Developing States of the Caribbean has been disrupted, but also prompted to adaptation in regards to the wave of global standardization of AML and CFT measures.

Through this light, an attempt will be made throughout the present paper in terms of digesting the organizational difficulties brought by both compliance factors such as AML/CFT as well as institutional ones such as risk-based approaches embedded in the workings of the FATF. At this point, the research is not going to try to initiate a policy-making process of financial change. Instead, it is going to be an academic attempt to depict the political and financial inconsistencies that the rise of AML-CFT enactments have brought in terms of financial transparency, socio-political compliance and financial accessibility in the Caribbean. Finally, the last research question to be enacted in the present project will be presented by inquiring into the dichotomy between the existence of relatively rich and politically powerful off-shore financial centres such as the Cayman Islands with the challenges brought by the demise of correspondent banking relationships and financial accessibility to its resident´s businesses and economic lives.

Now, as the main research questions have been settled, the division of the chapters will come as follows: First, a brief literature review on the economic and social vulnerabilities as well as ways of economic resilience within the framework of Small Island Developing States will give the path to project the current academic literature working on both the issue of financial de-risking in the Caribbean as well as the paroxical existence of off-shore financial centres within this region. This is expected to initiate the academic discussion on the "unintended consequences" of financial de-risking within the spectrum of both off-shore financial centres as well as commodity and trade-dependent economies.

In this sense, Chapter 3 will present a background analysis of the main political and institutional actions taken by developed economies in order to toughen Anti-Money Laundering and Counter-Terrorist Financing initiatives. Chapter 4 will follow with a subscription of the empirical evidence around shifting financial risk exposures from major international financial institutions vis-à-vis some of their Caribbean counterparties. This chapter will follow with providing empirical evidence on the so-called "unintended consequences" of the above mentioned initiatives embedded in the idea of financial de-risking through declining correspondent banking relationships introduced in the literature review of this project (Starnes et al. 2017). Therefore, the current institutional challenges facing some of the Caribbean economies on accessibility to the major financial as well as economic centres of the world that would be partly presented on the literature review will gain greater sense at this point. Chapter 4 will continue by providing with a specific case-study and qualitative analysis over the financial/economic effects of the de-risking phenomenon to commodity-dependent and small island economies. Consecutively, Chapter 4 will also challenge what has been proposed as analysis by means of a dichotomy between off-shore investment flows in the Caribbean and financial de-risking bringing accessibility and other economic challenges to most of their local populations.

Finally, conclusions will be drawn upon at the empirical and qualitative levels. In this regard, possible technological and political solutions such as the use of the Distributed Ledger Technology within financial institutions for the opening of information between banks and compliance regulators would be briefly structured. This specific section will also propose critical gaps for further analysis in the context of the present points of inquiry.

In regards to the methodology to be applied throughout this research, there are two main venues to initiate the above proposed analysis. Firstly, a time series recreation and analysis will be elaborated with the Consolidated Statistics data provided by the Bank of International Settlements (BIS.org). Thus, the Consolidated Statistics give path to an empirical measure and analysis of the major Financial Institutions' country risk exposures (BIS.org). The described empirical approach will become particularly relevant for chapters 3 and 4, which set the pace on the analysis in relation to the financial phenomenon of de-risking as with the specific financial and economic dynamics being experienced in the Caribbean.

Secondly, and in relation to the geographical focus of this paper, the research will provide with a case-study analysis of the financial and institutionalized rhetoric within most of the jurisdictions in the Caribbean. By means of inferring the current state of the literature on off-shore banking and lax taxation for financial services, this research paper will provide with an antithesis to the popular knowledge around the financial dynamics in the Caribbean. As such, the conflicting conceptualizations and analysis portrayed in chapters 3 and 4 around declining correspondent banking relationships and off-shore banking interactions in the Caribbean will become the essence of the above described case-study approach.

The methodological approach presented throughout this section has raised the importance of a comprehensive analysis of the current academic debates around the underlying topics. In such manner, the next section will spot a critical literature review provided by multilateral institutional circles as well as academic ones.

CHAPTER 2: LITERATURE REVIEW.

The academic literature and research around the politico-economic dynamics in Small Island Developing States (SIDS) is an incongruent portrayal of optimist and doubt towards these states' capacity to develop an environment of economic sustainability. In this sense, two words are deeply engaged in the economic literature within the geographic scope of Small Island Developing States (SIDS). Those are: vulnerability and resilience. In specific, authors such as Armstrong and Read (2003), Briguglio et al. (2009), Briguglio (2016), Briguglio and Melchor Vella (2018), Vlcek (2008) among others have opened an academic debate around the exogenous factors that determined the SIDS to be sometimes deemed for economic failure and social underdevelopment, or otherwise to be relatively successful case-studies of economic resilience and prosperity.

The academic career of Lino Briguglio has focused on the interplay between the externalities that impose an accumulated risk for economic and social failures to the SIDS. But also, the author has gone even deeper on the internal politico-economic factors that aid such states to have a trajectory of successful economic development and the portrayal of a healthy and relatively wealthy society. A concept becomes relevant at this point, and one that Briguglio has developed over his academic work, the one of resilience.

Economic resilience, within the analysis of the SIDS, is conceptualized as the political and economic ability to recover from an external shock as well as to successfully cope with the adverse effect of such a shock (Briguglio et al 2009; Briguglio 2016). Through this light, the presence of an external shock against the economic development of the SIDS comes through the portrayal of their vulnerabilities. These are usually in the form of their economic openness and export concentration (Briguglio et al. 2009). It is a recurrent academic pattern to analyse the SIDS' economies as deeply grounded and interconnected through international trade activities by means of an extreme concentration of their exporting commodities or services (Armstrong and Read 2003; Briguglio et al. 2009; Briguglio 2016; Santos-Paulino 2010).

In other words, as SIDS' economies are deeply interconnected with the rest of the world by terms of their own trading activities, their size and low political profile are both assumed to be factors that undermine their voice on international affairs. Therefore, causing a great sense of volatility in regards to any new exogenous economic and political development within the world's most powerful economies (McGillivray, Naudé and Santos-Paulino 2010). As such, orthodox theoretical dictations of economic development seem to be unavoidably nullified within the analytical framework of the SIDS given their above-described vulnerabilities and forms of resilience.

Armstrong and Read (2003) explored the applicability of the Lewis model for economic development within an understanding of small-states' economies. It is not a surprise that the authors conclude that the role of industrialization and the development of a large-scale manufacturing sector is useless in the context of economies that do not have the *right* amount of human capital nor natural endowments given their small geographical as well as demographic size (Armstrong and Read 2003). Through this lens, the authors highlight a sense of "economic sub-optimality" as well as narrow and extremely limited domestic markets being ingrained in the economies of the SIDS (Ibid. 2003). Paradoxically, and despite all of the above mentioned limitations, it appears that an academic consensus is attained regarding the extremely high exposure of the SIDS' economies towards international trade and financial markets (Armstrong and Read 2003; Briguglio et al. 2009; Briguglio 2016; Santos-Paulino 2010).

In the specific case of the Small Island Developing States of the Caribbean, the relevant academic reflexion has repeatedly featured the role of the provision of international financial services as a form of economic resilience for these jurisdictions (Armstrong and Read 2003; Briguglio et al. 2009; Briguglio 2016; Dabla-Norris and Srivisal 2013). In fact, Armstrong and Read (2003) go as far as devise a type of sectoral specialization grounded on the provision of off-shore financial services to multinational businesses that has allowed certain small islands in the Caribbean to have the type of economic development advertised throughout the Lewis model. In this case, Lino Brigulio's most beloved analogy of "the Singapore paradox" comes to live (Briguglio et al. 2009).

"The Singapore paradox" explains a collusion of the apparent economic vulnerabilities embedded in the SIDS with an enhanced economic resilience through relatively high GDP per capita levels (Briguglio et al. 2009). In this regards, the fact that a small island state faces an inherent exposure to economic and environmental shocks does not impede that through adaptive policy-making and strong private actors, all of these shocks are either irrelevant or significantly demised (Briguglio et al. 2009 and Briguglio 2016). The author, therefore, uses the politico-economic development of Singapore as a case-study whereby the financial deepening of this island's economy in conjunction with a state-led developmental path allowed Singapore to be positioned as a high-income state in spite of its inherited exposure to relevant negative exogenous factors (Briguglio et al. 2009).

As in the case of Singapore, some jurisdictions in the Caribbean had specialized in specific off-shore financial services as a manner of economic drive and resilience. This is the case of the Bahamas, the Cayman Islands, the Turks and Caicos and the like. These jurisdictions present us with the typical commonalities of vulnerability: these are seemingly unable to exploit any returns to scale, they apparently do not have any other option than to be extremely open to trade, their economies are highly volatile to international market price levels, they do not have any significant military protection, and they are relatively more prompt to natural disasters (Lee and Smith 2010). Above all, these Caribbean jurisdictions are popularly regarded and academically analysed as if they do not have little or any influence on the rule making processes within the international economy sphere (Ibid. 2010). However, Lee and Smith give a relevant and interesting point of focus on the smallness discourse carried out by popular and academic circles.

Fact and fiction are intertwined within the economic and political portrayal of smallness towards the Caribbean SIDS according to Lee and Smith (2010). This is because in the last years after the start of the new millennium, the Commonwealth of nations have tried to enact a greater political voice for several of the Caribbean economies within the international political circles of power (Lee and Smith 2010). However, given the apparent reduced economic options that the SIDS in the Caribbean have to develop a stable internal environment, some of these jurisdictions have adopted what the above mentioned authors called a "can't do, won't do" political discourse (Lee and Smith 2010: 1097-1098). In other words, as international political pressure increases in terms of cooperation/integration and enhanced economic as well as political compliance, several SIDS in the Caribbean have seen their main productive sources of income being paradoxically undermined by exogenous political discourses of global adaptation. Perhaps the most vulnerable SIDS within the Caribbean economic activity that is facing such external pressure is the provision of off-shore financial services.

Historically, the geography of off-shore financial centres has been developed in accordance to exogenous political and economic factors. In this sense, it has been determined that first the establishment of global empires (with a focus on the United Kingdom), then the shift of politico-economic hegemony from the U.K. to the United States, followed by the collapse of the Soviet Union and the rise of China as an economic powerhouse have all contributed for some jurisdictions in the Caribbean to develop their financial services accordingly (Haberly and Wójcik 2015). Since the 1960's, in specific, transactions have been booked and conducted through secretive and sometimes shady transnational legal systems within the Caribbean allowing wealthy individuals and multinationals to established a rationale of tax evasion and *foreign* legal protection (Ibid. 2015). In this sense, one of the most relevant conclusions taken from the research conducted by Haberly and Wójcik on global off-shore FDI networks is the deep historical and colonial underlining that had made the existence of financial nodes between the Anglo-Saxon and other developed and developing states possible (Ibid. 2015). Through this light, such financial nodes are secretive and reluctant to any type of legal compliance. All of these being possible and provided by their main conduits being some of the SIDS in the Caribbean and elsewhere (Ibid. 2015).

Hampton and Christensen (2011) explain the dangers of hosting off-shore financial services for a prolonged period of time. In this case, the authors highlight that by providing off-shore financial services, several of the Caribbean economies had been unable to gain from transferable knowledge or increased entrepreneurship in non-financial services (Hampton and Christensen 2011). What has occurred, instead, is that a "collective myopia" is latent within the political and social spheres of these economies in regards to the expansion and diversification of their economic activities (Ibid. 2011). Colonial history, and the deep financial interrelations with developed economies has ironically made some of the Caribbean SIDS unable to search for other means of economic production and political allegiance. Now that the Organization for Economic Cooperation and Development (OECD) in conjunction with the infamous FATF have prompted the rise of financial compliance, it is certain that some of SIDS in the Caribbean are locked in perplexity on how to move forward with their own economic activities (Ibid. 2011).

In attempt to echo the above mentioned preoccupations in regards to how the Caribbean SIDS could develop sustainable economic developments as well as a healthier politico-economic interaction with the rest of the world, studies such as the ones realized by Alexander et al. (2007), Hampton and Christensen (2011), Starnes et al. (2017), among others on the interactions become invaluable. In specific, the analysis between the rise of global institutional and financial compliance interpolated by the provision of off-shore financial services of the Caribbean SIDS becomes relevant at a time where neither regulators, financial institutions nor SIDS know how to move forward. Moreover, as the present project continues, the specific symptoms such as declining correspondent banking, the ever increasing transfer of risk by financial institutions and declining FDI and other investment instruments in the Caribbean are signals that a financial movement towards compliance and standardization is happening around the world. Nevertheless, the ones paying the bill as it will be demonstrated are the local and static economies of the Caribbean that cannot envisaged another developmental path than the one gifted several decades ago by its colonizers.

CHAPTER 3: ANALYTICAL BACKGROUND.

Money laundering is a global phenomenon driven by the widening and deepening of globalized economic relations. In this sense, the awakening of new institutional arrangements in the last three decades has enabled a re-conceptualization of financial illegality (Arnone and Borlini 2010). Ever more diffused imaginaries of national borders in addition to gaining perceptions of communicative directness with other localities have created a void on how to attain rule of law and governance on financial endeavours (Ibid. 2010). That is why the internationalization of certain policies and standards through the vigilant eye of few institutions has grown relevant in the fight against illegal financial actions (Arnone and Borlini 2010; FitzGerald 2004). Not only that, the internationalization of financial compliance and its embedded policies are cognizant, and perhaps a consequence, of an uncontrollable increase of transnational crime (Arnone and Borlini 2010; Goodhart et al. 1998).

The shifting paradigm around transnational crime, and of financial crime in particular, challenges the integrity and security of entire governments and established institutions of the current global order (Arnone and Borlini 2010). Thus, financial institutions are also interestingly portrayed as a double-sided coin. In other words, as these might lose credibility or reputation due to fallacies on the fight against transnational crime, financial institutions are also one of the most productive mechanisms through which such illegality is taking place (Arnone and Borlini 2010; Gilmore 2004). Now, it is pivotal to emphasise that transnational financial crime come most of the time through the image of well-organized criminal organizations, corporations and more recently of individuals. As such, the gradual conversion of transnational financial crime into everyday financial transactions and settlements is based by chronological economic and organizational reactions.

The 1980's showed a boom in illegal transnational drug trafficking. The 1990´s were recalled for an increase of organized crime and major claims of corruption. The 2000's were synonym of terrorism and of great financial instability in the West (Arnone and Borlini 2010; Shams 2004). With the described chronological increase on illicit financial and socio-political misbehaving, the institutional reactionary has been one of adaptation and normalization (Shams 2004). This is because of the deeper roots that the above described criminal developments have settled onto the workings of the global economy, trade and financial activities (Arnone and Borlini 2010).

Through this light, criminal groups and individuals' acts of criminality had achieved a consolidation of economic power and political leverage through their workings with the established financial and global political system (Arnone and Borlini 2010). Consequently, the combination of rapid penetration and legitimization of criminal activities in the form of unidentified groups or individuals have allowed illegal financial activities and other anti-social acts to simply become "invisible" or protected by their surrounding politico-economic environment (Ibid. 2010). Through this manner, acts of illegality such as money laundering or terrorist financing would erode the financial institutions as well as the political (tax) system in which they have been transmitted and realized (Ibid. 2010). It is important to emphasize that this paragraph is not a justifying shield for institutional arrangements involved in financial criminal acts. Instead, it tries to highlight the critical stakeholders through which financial corruption and illegality have taken place.

On that account, the development of institutionalized anti-money laundering measures began in lagged synchrony with the reality of increased illegal or "dirty" financial flows. At the end of the 1980's, the first supra-national efforts against such illegal financial acts were envisaged by increased supervision and gate-keeping of most of the world´s financial flows (Arnone and Borlini 2010). The establishment of the Financial Action Task Force (FATF) is the result of such efforts. Mainly conceived as a non-binding inter-governmental body, the FATF would develop throughout the 1990's into a pseudo supra-national legal regime safeguarding the legality of its member´s financial flows as well as of their financial accountability (Ibid. 2010). Later, in the aftermath of the terrorist attacks of September, 2001; the FATF got interested in covering and preventing the financing of terrorist activities, at least in the developed markets of the world (Arnone and Borlini 2010; Norton and Shams 2002).

The FATF was subsequently amended and revised through the paradigm of *The Forty Recommendations* for the implementation and development of anti-money laundering measures within its member states. These so-called *Recommendations* are not only the portrayal of the institutional nature of the FATF. In a deeper sense, such listing of anti-money laundering measures represents a paradigm shift of financial compliance and accountability (Arnone and Borlini 2010). The anti-money laundering and counter-terrorism financing measures achieved through the conception and reproduction of the FATF are the cascading of several national laws and political approaches to financial illegality (Ibid. 2010). In fact, the FATF takes on a multi-disciplinary approach on its own *Recommendations* in order to accommodate different nationalistic agendas on financial law development (Ibid. 2010).

The FATF approach is fundamentally compressed in four points: criminalization of money laundering activities, enhanced methods and solutions for tracing and confiscating the financial/material rewards of such illegal activities, prevention of money laundering and its use of the global financial system, and the improvement of international cooperation (Arnone and Borlini 2010; FitzGerald 2004).

Despite its supra-national ambitions of ruling and policy alignment in addition to its increased cooperation with multilateral organizations such as the World Bank and the International Monetary Fund, the FATF has not been developed as a binding agreement by its member states (Arnone and Borlini 2010; Campbell-Verduyn 2018). Instead, and pivotal for the main message of the present chapter, the FATF has introduced a risk-based strategy or approach for the assessment of international financial flows and activities (Arnone and Borlini 2010; Campbell-Verduyn 2018).

A risk-based approach within the scope of the FATF works as a balancing act between regulatory standardization and non-direct intervention in each state´s sovereign affairs as well as their policy-making process. This is reflected in the sense that the current ambition of anti-money laundering and counter-terrorist financing policies is to be aligned to a coordinative risk assessment of each transaction, client, and jurisdiction (Arnone and Borlini 2010; FitzGerald 2004). In other terms, a risk-based approach encourages each financial actor, and specifically financial institutions, to take greater care of perceived risky transactions and resource allocation to possible non-compliant parties (Arnone and Borlini 2010; FATF 2008).

It might seem that the risk-based approach enacted by the FATF acts as a scape-goat in order to prevent financial and market obstruction. However, the already mentioned strategy is possibly being over emphasised by the relevant financial institutions as a manner to prevent negative local and to some extent international recrimination or eroding reputation. It is feasible to regard risk-based strategies as more flexible and adaptive to each institutional and national environment as Arnone and Borlini do. Nevertheless, such strategies have also become justifying discourses to enhance models of bank secrecy and mistaken visions over certain jurisdictions regarded as "too risky" or "non-compliant" (Campbell-Verduyn 2018). As much as developed financial institutions and jurisdictions try to avoid perceived financial risk, most of the laundered receipts of money are counterintuitively invested in the real economies of those so-called compliant and developed markets (Masciandaro, Takats and Unger 2007).

The above introduced phenomenon is going to be expanded in Chapter 2 and 3, but it nonetheless serves as a premise for another relevant point. That is, the relatively increase on information asymmetries in regards to customer due diligence and compliance costs for both political and financial institutions.

It has been established that the risk-based approach strategies embedded in the predicaments of the FATF have allowed for some flexibility on how each of the national political and financial institutions apply their anti-money laundering and counter-terrorist financing policies. Even though risk assessments are deemed to favour well-developed and regulatory compliant markets, confusion is growing on the side of financial institutions on how to satisfy all or most of the malleable regulations coming from their own as well as their external regulatory agendas (English and Hammond 2018). In this case, Customer Due Diligence (CDD) widely versed within the financial buzz of Know-Your-Customer (KYC) premise has acted as a double-edged sword of superficial institutional prudency contrasted by deep miscommunication between external political regulators with internal financial actors.

Arnone and Borlini (2010) are adamant of portraying the benefits of the internationalization of anti-money laundering and counter-terrorist financing regulation through the eyes of the FATF protocol. In specific, according to the authors, such regime has encouraged a "virtuous cycle" between international and national legal systems (Arnone and Borlini 2010: 250). However, the alluded cycle seems rather unsynchronized between the vast majority of jurisdictions, and even worst, between financial institutions and local authorities in the context of reporting Know-Your-Customer (KYC) processes. It is certainly evident that financial institutions are required to report transactions to the relevant authorities and perform regular Customer Due Diligence on their clients (FitzGerald 2004). As such, operational and transactional costs have been on the rise in the last decades whereby transparency of information sharing between regulators and financial institutions is expected to result in an increase on security (Goodhart et al. 1998; FitzGerald 2004). Still, the perceived costs oversee the benefits of a prudential approach in terms of an informational void.

Multiple national and international approaches on Customer Due Diligence (CDD) are colluding throughout time. This has intensified the movement of financial institutions towards the management of capital market assets and the popularity of unregulated transfer systems (FitzGerald 2004). Two factors derive from such transition. The first one being projected by the fact that less financial information is available within the context of capital market transactions and unregulated transfer systems (Ibid. 2004). The second one is that the lack of capital controls has allowed wealth to be moved to jurisdictions where bank secrecy is normalized and enacted, but not within the usual off-shore suspects (Cobham, Jansky and Meinzer 2015; FitzGerald 2004).

At this point, it has been suggested that the market incentives for financial institutions are against regulation, instead of working in alignment with it (FitzGerald 2004). The obvious cases are the ones presented at the beginning of this research project. It is then, probably adequate to say that bankers do prefer profit over compliance, or in the words of transnational crime researcher Mark Galeotti:

> *"The problem is not a witch hunt, but rather that for bankers, whether in the Baltic states, or London, or Delaware, or Frankfurt, the rewards from turning a blind eye to shady business still outweigh the risks"* (Galeotti in Bloomberg News 2018).

Interestingly, FitzGerald proposes a more rigorous economic approach on the enforcement of compliance from the relevant financial institutions. In here, an "internalization" of the externalities caused by non-compliant institutions and jurisdictions is necessary in order to make such financially dubious activities unprofitable for the ones handling the transactions (FitzGerald 2004: 399). The author continues with the idea that the above mentioned economic disincentives on financial institutions in addition to a reinforcement of civil sanctions would allow for more compliant behaviour and strict implementation of

Customer Due Diligence procedures (Ibid. 2004). This has been up to a certain degree the case over the dynamics behind the phenomenon of financial de-risking as well as the increased institutional preoccupation to follow the rules. Despite all of these efforts, a lack of consistency on the financial regulatory side circumvents around the issue of compliance.

A Thomson Reuters survey (2017) of 1,023 decision-makers within the biggest Financial Institutions in the world have shown how lack of consistency and greater complexity from local financial regulations is affecting the finance business. In this sense, 33% of respondents have considered that the volume of financial regulatory changes is the greatest challenge that Financial Institutions face while undertaking Know-Your-Customer procedures (Thomson Reuters 2017). In depth, another similar analysis undertaken by English and Hammond (2018) have portrayed the uncertainty that local as well as international regulators are projecting towards the global financial system. It has been, therefore, established that during 2017 an approximate of 56,000 regulatory alerts were captured from over 900 global regulatory bodies by several Financial Institutions (English and Hammond 2018). On average, such figures would represent 216 regulatory updates per day (Ibid. 2018).

What the numbers introduced above represent is a constant dislocation of the global regulatory system with the compliant capacity of the relevant Financial Institutions. Such permanent state of regulatory divergence disagrees with the initial ideology of risk-based policies for anti-money laundering and counter-terrorist financing. Indeed, the opportunity that a discretionary risk-based approach provides to each of the national regulators in order to achieve a "common goal" against financial crime while keeping sovereignty in good order is paradoxically exacerbating lack of clarity and communication between political and financial actors (Campbell-Verduyn 2018). The danger of complex anti-financial crime polity implementation is that Financial Institutions would search for the cheaper, fastest and most effective exit alternatives (Campbell-Verduyn 2018; English and Hammond 2018). The to-be-explained "de-risking" phenomenon is one of the preferred exit methods. However, other approaches such as technological innovation and implementation as well as increased inter-corporate cooperation have led the path for a half sorted out compliance process within Financial Institutions (Campbell-Verduyn 2018).

In a manner of an interim conclusion, it is pertinent to emphasize that as local and international financial regulation keeps on the growth within the premises of a risk-based approach, Financial Institutions are deemed to be politically troubled. Then, it is no surprise that at a time in which Financial Institutions try to keep ahead with regulatory additions whether at the national or international levels, other paths for profit realization are looked upon by these institutions. Creativity on financial transactions have flourished within this framework as financial technological innovation have also allowed to. The chapter of the present paper would continue showing the double standards at the discourse as well as the practical level managed by Financial Institutions and to some extent, regulators.

CHAPTER 4: IMPACT OF ANTI-MONEY LAUNDERING AND COUNTER-FINANCING OF TERRORISM STRATEGIES ON THE SMALL ISLAND DEVELOPING STATES OF THE CARIBBEAN.

Empirical evidence of what is to be told about the decline of correspondent banking relationships in emergent and developing economies will be introduced throughout the section two of this chapter. But first, an empirical analysis of the credit risk exposure in the Caribbean coming from major American financial institutions will be provided as an introductory assessment of financial risk behaviour in this part of the world. In specific, this is also an opportunity to analyse the proposed case of the Caribbean and its declining correspondent banking relationships with the North American financial market as well as its outward shifting of net risk transfers. As such, both declining correspondent banking relationships between major U.S. financial institutions and regional/local Caribbean banks and negative net risk transfers are to be considered as a proxy for the phenomenon of de-risking in the Caribbean.

The purpose of this section is to introduce the linkage between the results of the Consolidated Banking Statistics as well as the decline of correspondent banking relations in the Caribbean with the rise of anti-money laundering and counter-terrorist financing compliance processes. Something that will lead the path for an in-depth analysis of the described relationship in the following chapter. For what has been mentioned, two sources of data will be portrayed in the following order.

Firstly, the Bank of International Settlements' (BIS) annual Consolidated Banking Statistics that is part of the International Banking Statistics will serve for the analysis on declining financial risk exposures between U.S. financial institutions vis à vis selected Caribbean counterparties. In depth, the International Banking Statistics gathers quarterly data on the balance sheets of each of the BIS sixty member states (BIS.org)[1]. A point of deference is to be made between both of its children datasets, the Consolidated Banking Statistics and the Locational Banking Statistics. That is, the Consolidated Banking Statistics measures international banking activity with a focus on where the ultimate bank´s parent is headquartered (BIS.org). The Locational Banking Statistics, instead, measures the same international banking activity with a focus on the location of the banking office (BIS.org).

This research has deemed appropriate to utilize the Consolidated Banking Statistics (CBS) because these capture the ultimate claims of banking groups that are based in either of the sixty member states of the Bank of International Settlements (BIS.org). Consequently, by excluding intragroup (affiliates of the same corporate group) the CBS is cognizant of the location where the underlying financial decisions are taken (BIS.org). In most of the cases, these decisions are ultimately granted by the controlling parent of the financial group. Finally, the risk exposure measurement will be on the immediate counterparty, which would allow for an empirical analysis on the country and sector to which the funds are imparted (BIS.org)[2].

[1] https://www.bis.org/statistics/about_banking_stats.htm?m=6%7C31%7C637
[2] https://www.bis.org/statistics/glossary.htm?&selection=304&scope=Statistics&c=a&base=term

After the above introductory analysis has been concluded, the present section will dig-deeper on the empiricism around declining risk overtaken by major North American financial institutions through a portrayal of their net risk transfers with the Caribbean. In this sense, net risk transfers are measured by the BIS as inward minus outward risk transfers (BIS.org)[3].

Inward risk transfers increase the credit risk exposure in face of a given counterparty country while outward risk transfers reduce such exposures by means of a transfer to another counterparty country (Aldasoro and Ehlers 2017). Through this view, it would be appropriate to say that the measurement of net risk transfers highlights how major financial institutions assess and manage credit risk exposures across counterparty countries (Ibid. 2017). This is because the utilization of such risk transfers would be determined by the perceived "risk-iness" of counterparty countries (Ibid. 2017). The financial instruments used for risk transfers will be later analysed as this section continues.

Secondly, the Society for Worldwide Interbank Financial Communication (SWIFT) data will be additionally contemplated in line with the results given by the Consolidated Banking Statistics and net risk transfers. SWIFT is a form of standardized interbank communication for the realization of national as well as of international financial transactions in the form of payments, securities, treasury and trade (SWIFT.com)[4]. It is used by more than 11,000 financial institutions in 200 countries, which makes it a compelling tool for banks to communicate certified instructions related to cross-border transactions

[3]https://www.bis.org/statistics/glossary.htm?&selection=285&scope=Statistics&c=a&base=term
[4] https://www.swift.com/about-us

(SWIFT.com)[5]. Through this manner, any type of financial institution has the possibility to connect with one another in the context of structured electronic messages in order to perform business processes (SWIFT.com)[6]. The data to be analysed, therefore, is going to be on the basis of the standardised messages exchanged between major well-established financial institutions and their Caribbean counterparties in the Bahamas, Barbados, Belize, Bermuda, Cayman Islands and Turks and Caicos Islands.

Given the amount of secrecy and restrictions around the utilization of SWIFT data, this research will not analyse it directly from its original provider. Instead, the empirical analysis on the global decline of correspondent banking relationships conducted by the Financial Stability Board in 2017 will facilitate the investigative purposes of the above described sub-section (Financial Stability Board 2017).

SECTION I - BANK OF INTERNATIONAL SETTLEMENTS DATA: CONSOLIDATED BANKING STATISTICS AND NET RISK TRANSFERS.

The first strand of the data that is going to be interpreted relies on the quarterly Consolidated Banking Statistics through the form of a time-series scale parting from the year 1983 until quarter 1 of 2018. The reporting country in this case is the United States including domestic banks, but excluding domestic positions. In this sense, the reporting basis is on its immediate counterparties with a balance sheet's positioning on international claims only. The maturity of such positions are on a generalized basis that includes maturities ranging from up to and

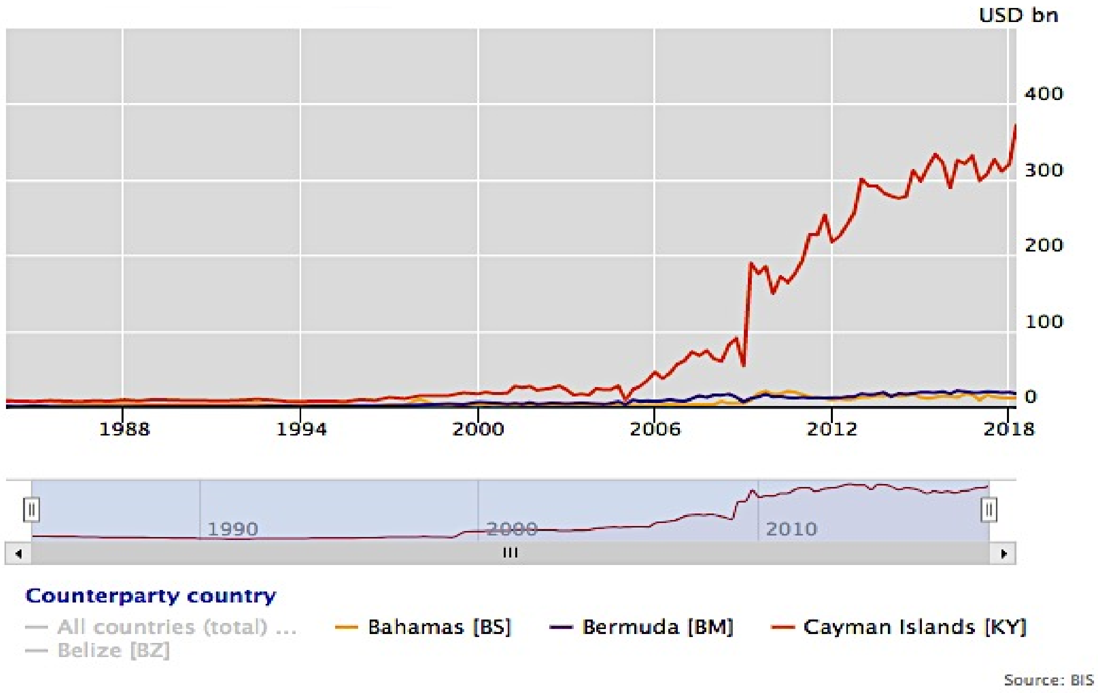
[5] https://www.swift.com/about-us/discover-swift/messaging-standards
[6] https://www.swift.com/about-us/discover-swift/messaging-standards

including one year, over one year and up to two years, and over two years. The selected counterparty jurisdictions are the Caribbean islands of the Bahamas, Bermuda, and Cayman Islands. Unfortunately, no data has been gathered for the above mentioned positioning on Belize, Barbados and Turks and Caicos Islands. The counterparty sectors include all formal financial institutions.

The first striking position visible in Figure 1 is the one of the Cayman Islands. In comparison to the Bahamas and Bermuda, the Cayman Islands lead the way as a counterparty of U.S. credit origination since the beginning of quarter 2 of 1995 with U.S.D. 6.54 Bn in total amounts outstanding (BIS.org)[7]. This is compared with the Bahamas and Bermuda that had a total amounts outstanding of U.S.D. 3.2 Bn and U.S.D. 835 Mn respectively (Ibid.). The specific upward trend of the Cayman Islands continues until quarter 3 of 2004 with U.S.D. 27.29 Bn in amounts outstanding. Characteristically, the Bahamas and Bermuda do also follow such upward trend until quarter 3 2004 with U.S.D. 1.77 Bn and U.S.D. 6.68 Bn respectively.

[7] https://stats.bis.org/statx/srs/tseries/CBS_PUB/Q:S:US:4R:F:I:A:A:TO1:A:5J?t=B2&m=S&p=20181&i=32.2&x=L_CP_COUNTRY.10.CL_BIS_IF_REF_AREA.5J&o=s:line

Figure 1: Consolidated Banking Statistics (U.S. – Bahamas, Bermuda, Cayman Islands).



However, on quarter 4 of 2004 there is a relatively dramatic downfall for the tree jurisdictions finalizing with U.S.D. 8.45 Bn for the Cayman Islands, a less impressive U.S.D. 1.22 Bn for the Bahamas, and U.S.D 2.96 Bn for Bermuda in amounts outstanding (Ibid.). In addition, the downward spot could be associated with the stricter compliance measures taken by the U.S. Department of State and the FATF in regards to off-shore banking and anti-money laundering/counter-terrorist financing. A more in-depth explanation follows on the next chapter.

Focusing on the Cayman Islands one is set to encounter a significant re-stabilization of the upward trend on amounts outstanding following the draw-back at quarter 4 of 2004. Such positive trend continues until a small peak in quarter 3 of 2008, but remaining below U.S.D. 100 Bn with a total of U.S.D.

90.67 Bn in total amounts outstanding (BIS.org)[8]. Nevertheless, the positive trend was drastically reversed within quarter 3 and 4 of 2008 in the awakening of the global financial crisis.

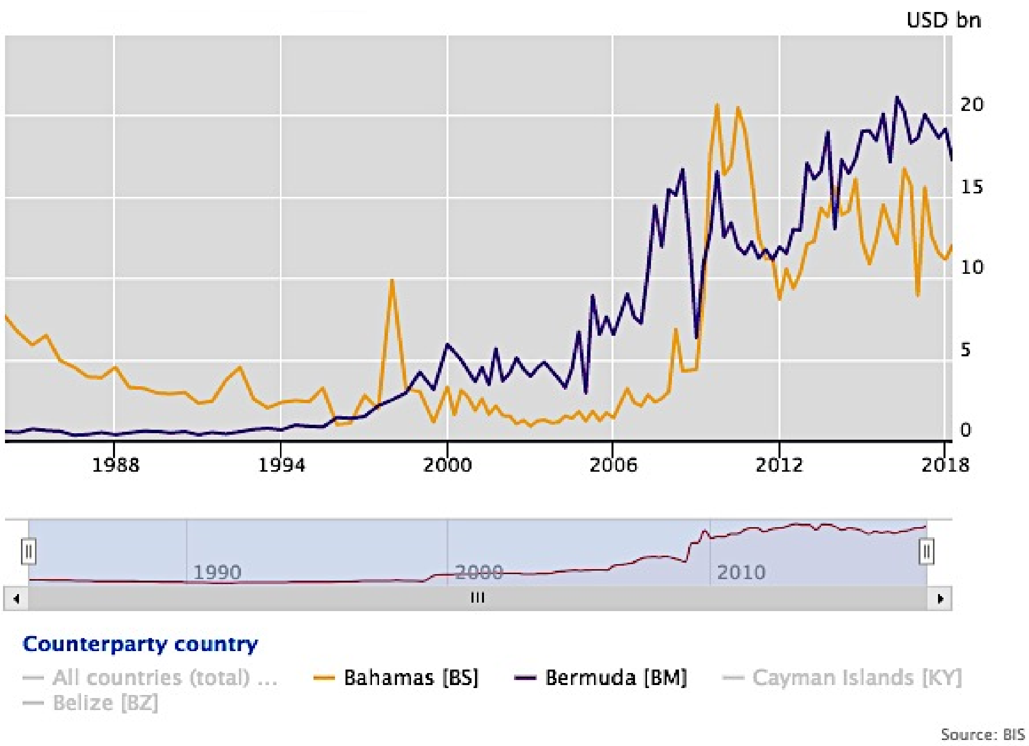
What follows is a shift of events with a positive shot on amounts outstanding coming from the U.S. totalling U.S.D. 189.79 at quarter 1 2008. This could be accounted as a sign of the reliance of the Cayman Islands as an offshore financial centre (despite a public American discourse against such dynamics) in the midst of the worst global financial crisis since the Great Depression. Such impressive positive amount of credit and other forms of financing continue on the records with relatively small drawbacks in quarter 4 of 2009, quarter 4 of 2011 and quarter 2 of 2014. In contrast with the perception of declining correspondent banking and the de-risking phenomenon, it would seem that the Cayman Islands had in fact remained relatively strong against the described phenomena. Indeed, the Cayman Islands could be considered as a powerful regional financial centre given the present empirical analysis.

A slightly different structural picture is portrayed by the Bahamas and Bermuda. This is shown through the fact that until quarter 1 of 2008, both jurisdictions had had amounts outstanding below the U.S.D. 100 Bn level. Zooming in, figure 2 shows a rather volatile relationship over time on the incurred amounts outstanding coming from American banks on both of their Caribbean counterparties, specifically. In this case, it is inferred that American credit remains sluggish throughout the end of the 1990's as well as the first nine years of

[8] https://stats.bis.org/statx/srs/tseries/CBS_PUB/Q:S:US:4R:F:I:A:A:TO1:A:5J?t=B2&m=S&p=20181&i=32.2&x=L_CP_COUNTRY.10.CL_BIS_IF_REF_AREA.5J&o=s:line

the 2000's in the Bahamas. Interestingly, at the worst period of the global financial crisis, amounts outstanding dramatically increased in the Bahamas reaching two peaks at quarter 3 of 2009 and quarter 2 of 2010 of U.S.D. 20.65 Bn and U.S.D. 20.46 Bn respectively. As with the case of the Cayman Islands, both of these increases might be a sign of the peculiarities of the financial system in this part of the Caribbean.

Figure 2: Consolidated Banking Statistics (U.S. – Bahamas, Bermuda).



Bermuda presents a marginally different panorama from the one described above. American credit provision had constantly been on the rise since the beginning of the 2000's. However, and in contra-position with both the Bahamas and the Cayman Islands, a detraction on American amounts outstanding is noticed throughout the mid to late-stages of the global financial crisis. As such, generalizations on the behaviour of credit impulsion in the Caribbean should be carefully proposed despite the commonalities presented throughout this section.

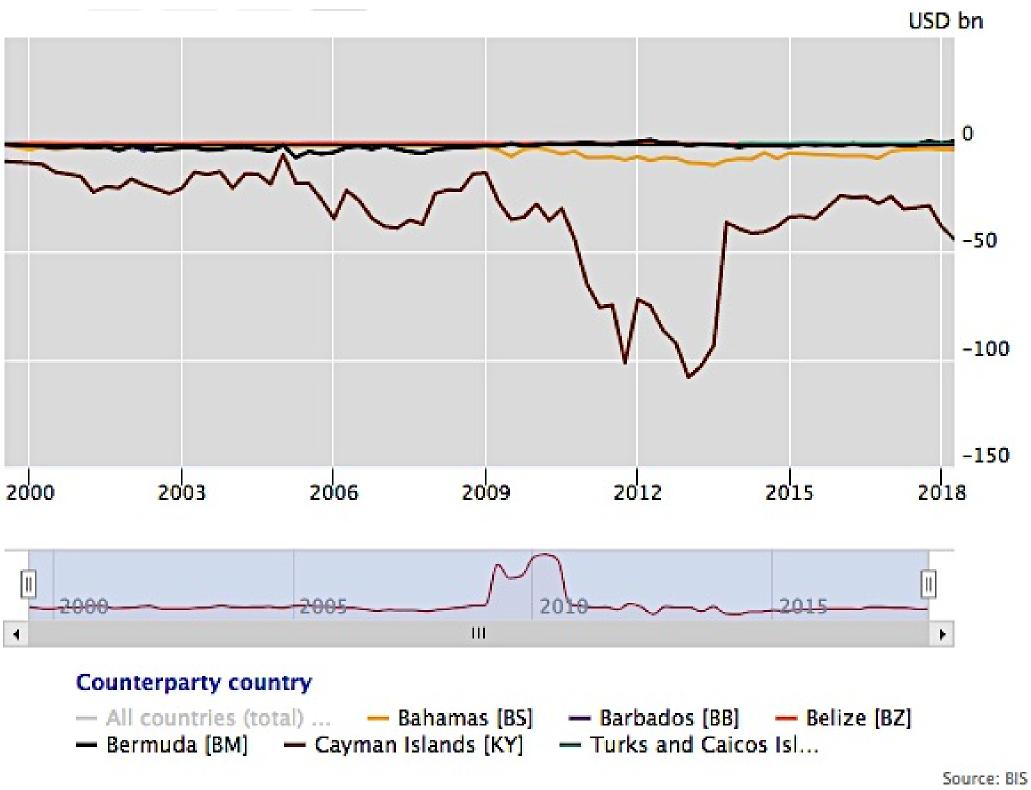
Until now, the financial relationships between American financial institutions and some of their Caribbean counterparties could be described as positive ones. In fact, given the empirical attest, it would seem rather inappropriate to talk about a significant credit de-risking phenomenon at least on the three jurisdictions that had been analysed. Nonetheless, by going deeper into the analysis of net risk transfers between American financial institutions within the Caribbean, the above proposed relationship changes. This is perhaps due to the fact that net risk transfers provide with a deeper assessment on how major financial institutions interplay with several financial instruments such as parent and third-party guarantees, credit derivatives (purchased protection on credit risk) as well as collateral transfers in order to prevent a complete fall-down or damage of their balance-sheets (Aldasoro and Ehlers 2017). In other words, the analysis on net risk transfers would be cognizant of the intrinsic relationships between major international banks or between banks and other financial institutions for a demise on their actual credit risk exposure on certain jurisdictions (Ibid. 2017).

Figure 3 shows a striking inverse position on American risk exposure in face of its Caribbean counterparties by means of net risk transfers. In this case, the Barbados, Belize and Turks and Caicos Islands had been included in the projection in order to expand on the analysis (BIS.org)[9]. Parting from the prominent case of the Cayman Islands, and counterintuitively from the analysis of this jurisdiction's amounts outstanding, figure 3 shows a rather different story. Since

[9]https://stats.bis.org/statx/srs/tseries/CBS_PUB/Q:S:US:4R:Q:C:A:A:TO1:A:5J?t=B2&m=S&p=20181&i=32.12&x=L_CP_COUNTRY.10.CL_BIS_IF_REF_AREA.5J&o=s:line

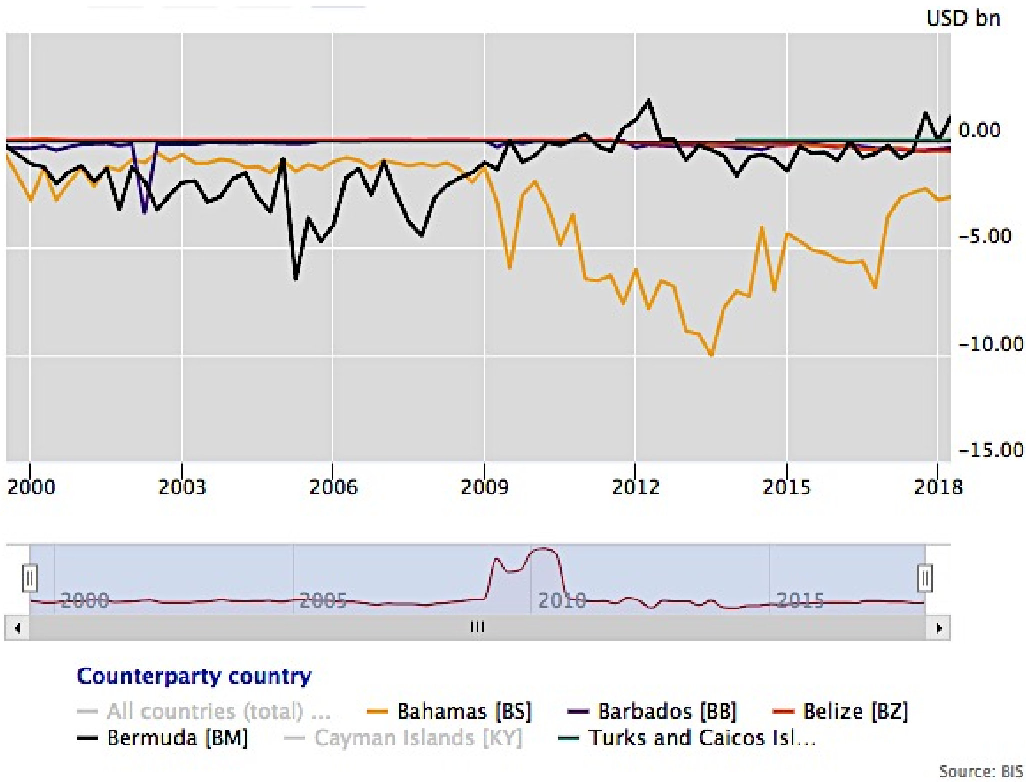
the beginning of the dataset at quarter 2 of 1999, it is regarded that the Cayman Islands portray a negative risk transfer from its American originator. In fact, such negative relationship remains as such throughout the entire time-series until quarter 1 2018. This phenomenon would mean that the perceived upward trend presented on figure 1 regarding amounts outstanding from American financial institutions in the Cayman Islands is somewhat nullified by the actual negative net risk transfers exposed in figure 3.

Figure 3: Net Risk Transfers (Bahamas, Barbados, Bermuda, Belize, Cayman Islands, Turks and Caicos Islands).



Following the logic of the net risk transfer computation, inward minus outward risk transfers, the case of the Cayman Islands shows that given the negative trend there has been more outward shifts on risk exposures than inward ones from American financial institutions. Through this light, the Cayman Islands is a case of a tremendous outward re-allocation of risk exposures from major American financial institutions to other jurisdictions. Aldasoro and Ehlers (2017:18) have calculated that around U.S.D. 200 Bn of net foreign claims were transferred out of the Cayman Islands in June 2017. The major negative shift that happened in this jurisdiction was at quarter 4 in 2012 were the totalling of inward minus outward risk shift was on the verge of U.S.D. 109 Bn (BIS.org)[10].

Figure 4: Net Risk Transfers (Bahamas, Barbados, Bermuda, Belize, Turks and Caicos Islands).



Leaving the case of the Cayman Islands behind, the same type of negative outlook prevails for the remaining jurisdictions. Even though, Bermuda does show a peak on net risk transfers at quarter 1 of 2012, the overall perspective is one of negative net risk transfers (BIS.org)[11]. The Bahamas are another

[10] https://stats.bis.org/statx/srs/tseries/CBS_PUB/Q:S:US:4R:Q:C:A:A:TO1:A:5J?t=B2&m=S&p=20181&i=32.12&x=L_CP_COUNTRY.10.CL_BIS_IF_REF_AREA.5J&o=s:line
[11] https://stats.bis.org/statx/srs/tseries/CBS_PUB/Q:S:US:4R:Q:C:A:A:TO1:A:5J?t=B2&m=S&p=20181&i=32.12&x=L_CP_COUNTRY.10.CL_BIS_IF_REF_AREA.5J&o=s:line

exemplification of dramatism on the basis of a prevailing outward shifting in American credit risk exposures. The most prominent negative net risk transfer is at quarter 2 of 2013 with U.S.D 10.04 Bn portraying the stable recovering after the global financial crisis in the American financial market. Such negative trend on net risk transfers remains for the case of the Bahamas until quarter 1 of 2018, but it is positively shifted for the case of Bermuda at quarter 3 of 2017 onwards.

Figure 5: Net Risk Transfers (Barbados, Belize, Turks and Caicos Islands).

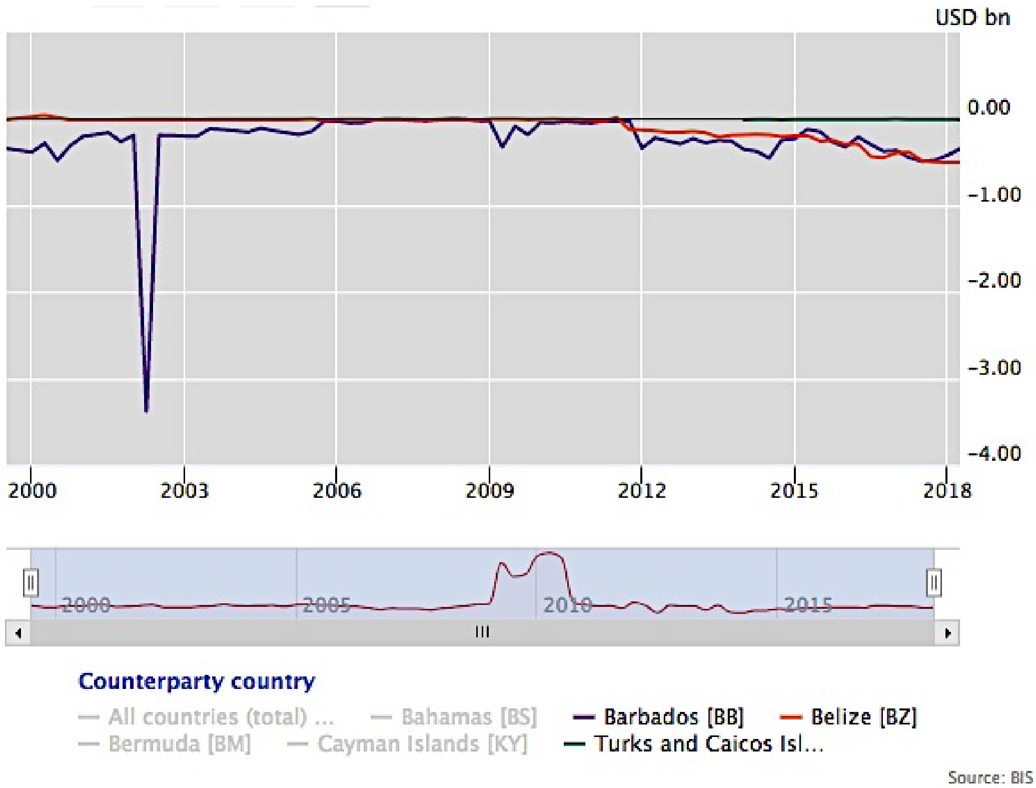


Figure 5 portrays the remaining cases of the Barbados, Belize and the Turks and Caicos Islands within a net risk transfer perspective (BIS.org)[12]. Interestingly, the Barbados claim a downward peak of net risk transfers at quarter

[12]https://stats.bis.org/statx/srs/tseries/CBS_PUB/Q:S:US:4R:Q:C:A:A:TO1:A:5J?t=B2&m=S&p=20181&i=32.12&x=L_CP_COUNTRY.10.CL_BIS_IF_REF_AREA.5J&o=s:line

1 of 2002 right after the wide-spread propagation of the *Forty + nine Recommendations* from the Financial Action Task Force given the terrorist attacks in the United States in 2001. A stable trend is considered for both Barbados and Belize from 2005 until 2012. Then, a prominent exacerbation of outward risk transfers is contemplated from 2012 until quarter 1 of 2018. The same phenomenon applies for the Turks and Caicos Islands from 2013 onwards.

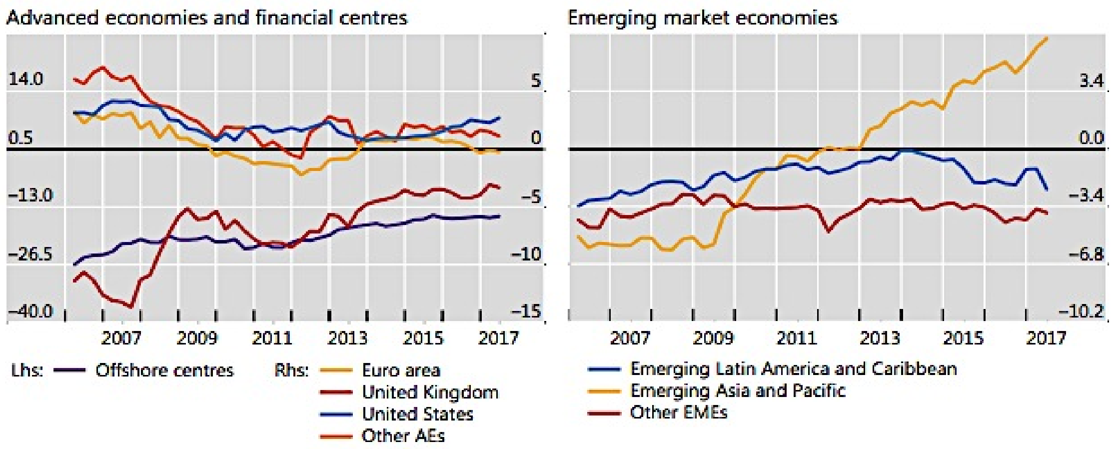
Two pivotal characterizations are to be finally highlighted after the introduction of the net risk transfer notion and in the empirical context of the Caribbean. The first one relies on the financial mechanisms in which parent financial institutions transfer outstanding credit risk out of the Caribbean. The second one is the justification for such behaviour.

It has become a commonality for parent financial institutions in developed markets, and in the U.S. in specific, to transfer credit risk from several emerging markets and off-shore financial centres back to the parent´s country of origin (Aldasoro and Ehlers 2017). As the parent financial institution could either maintain a branch in the counterparty country of interest or simply it maintains a corporate relationship with a regional/local bank, the use of financial guarantees had been increasingly used in order to transfer the risk out of the counterparty jurisdiction or branch back to the parent´s origin (Ibid. 2017). This is in other words ascribed as the increasing outward risk transfer that was specifically analysed within the Caribbean. The extreme case, within this context, is the one of the Cayman Islands. Such jurisdiction is usually described as an off-shore financial centre whereby several major North American banks have established their branches (Ibid. 2017). Negative net risk transfer is particularly prominent in the Cayman Islands, which gives insight on how the parent financial institution in the U.S. avoids full institutional as well as credit exposure in the Cayman Islands and the other already analysed jurisdictions (Ibid. 2017).

It is usually encountered that if and only if the foreign operations of such major banks are guaranteed either by their parents in developed markets or by other third-parties in the home country, credit risk would be transferred back to the Caribbean jurisdictions (Aldasoro and Ehlers 2017). This type of behaviour gives way to the second relevant characterization to be analysed within the net risk transfers basis.

Negative net risk transfers are also the portrayal of the perceived "riskiness" of sovereign as well as counterparty financial institutions (Aldasoro and Ehlers 2017; Starnes et al. 2017). Such perception will be deeply analysed in the following section of this chapter, but within the framework a net risk transfer assessment, it is relevant to highlight that negative trends are not only found in the Caribbean. As such, the Middle East, Sub-Saharan Africa and several parts of Latin America present overall negative net risk transfers (Ibid. 2017). These are no other thing than extremely negative outward risk transfers directed towards the parent financial institution established in a developed market (Aldasaoro and Ehlers 2017; Starnes et. al 2017). Figure 6 and 7, both taken from Aldasaoro and Ehlers (2017: 20-22) portray the concomitant phenomenon of negative net risk transfers in some emergent and developing markets directed towards developed ones. In this sense, the authors try to explain such phenomenon on a hedge risk as well as credit risk rating rhetoric (Ibid. 2017).

Figure 6: Evolution of Net Risk Transfers, by Counterparty Region (Aldasaoro and Ehlers 2017).

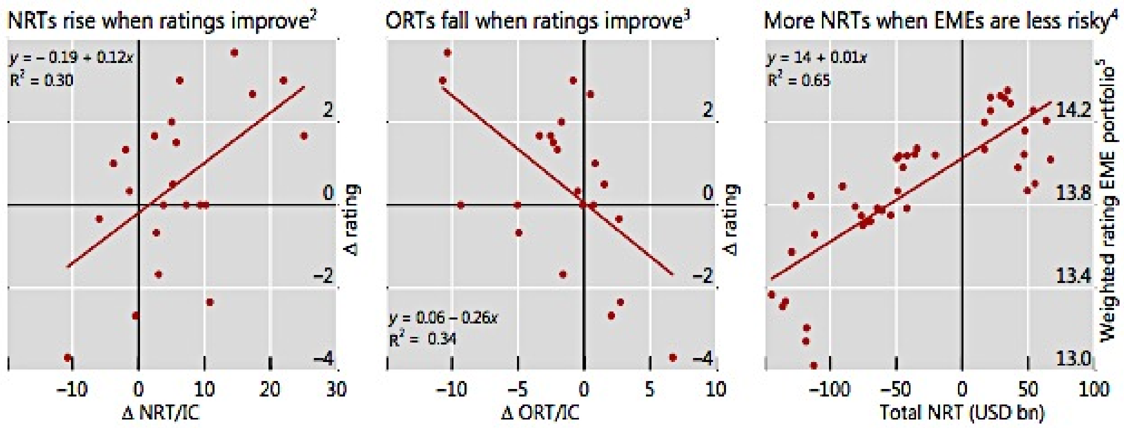


Further information on the consolidated banking statistics is available at www.bis.org/statistics/consstats.htm.

[1] At quarter-end. Amounts for the respective period are reported already converted to US dollars. There are 27 banking systems reporting risk transfers. German, Norwegian, Swiss and US banks are excluded due to changes in reporting or for confidentiality reasons.

Sources: BIS consolidated banking statistics (immediate counterparty basis); authors' calculations.

Figure 7: Risk Transfers and Rating Changes in Emerging Market Economies (Aldasaoro and Ehlers 2017).



[1] EMEs = AR, BR, CL, CN, CO, CZ, HU, ID, IN, KR, MX, MY, PH, PL, QA, RU, SA, TH, TR, TW, UA and ZA. There are 27 banking systems reporting risk transfers. Austrian banks are excluded due to reporting changes. Rating is an average of the ratings of Moody's, Standard & Poor's and Fitch taken from Bloomberg, transformed to a numerical scale; higher numbers indicate a better rating. Ratings were available from two agencies (Standard & Poor's and Fitch) for India, and one (Standard & Poor's) for Chinese Taipei. [2] For each EME: change in the ratio of net risk transfers (NRT) to foreign claims on an immediate counterparty (IC) basis between Q4 2006 and Q4 2016 versus change in country rating over the same period. [3] For each EME: change in the ratio of outward risk transfers (ORT) to foreign IC claims between Q4 2006 and Q4 2016 versus change in country rating over the same period. [4] For each quarter in the period Q4 2006 to Q4 2016 for the entire group of EMEs: total dollar value of all NRTs versus weighted average rating of EME portfolio. [5] IC foreign claims-weighted average rating of the group of EMEs.

Sources: Bloomberg; BIS consolidated banking statistics (IC basis); authors' calculations.

On the hedge risk side, the authors correspond the declining of net risk transfers to a negative ratio of outward risk transfers to foreign claims based on international credit that captures how major international banks hedge counterparty risk (Aldasaoro and Ehlers 2017). On this perspective, the present research will go a step forward by conjugating such increased "hedging" with the empiricism of declining correspondent banking relationships and the overall perception of de-risking. At that point, it would also be relevant to analyse how both net risk transfers and declining correspondent banking relationships are being exacerbated by increased anti-money laundering and counter-terrorist financing compliance factors. However, before moving to that point, Aldasaoro and Ehlers have left some more input regarding the net risk transfer perspective through figure 7.

The authors have compellingly made an introduction on the responsive behaviour of major financial institutions in developed markets when their counterparties' institutional or sovereign risk rating improves or not. As such, it is portrayed that a positive correlation between improved credit risk rating in the counterparty side and positive net risk transfers exists (Aldasaoro and Ehlers 2017). In specific, it is also appreciated that outward risk transfers would fall if the counterparty risk rating improves (Ibid. 2017). Such exposition of correlations is still in early stages of analysis, but it does leave a thought-provoking line of future research.

SECTION II - SOCIETY FOR WORLDWIDE INTERBANK FINANCIAL COMMUNICATION DATA: DECLINING CORRESPONDENT BANKING RELATIONS IN THE CARIBBEAN.

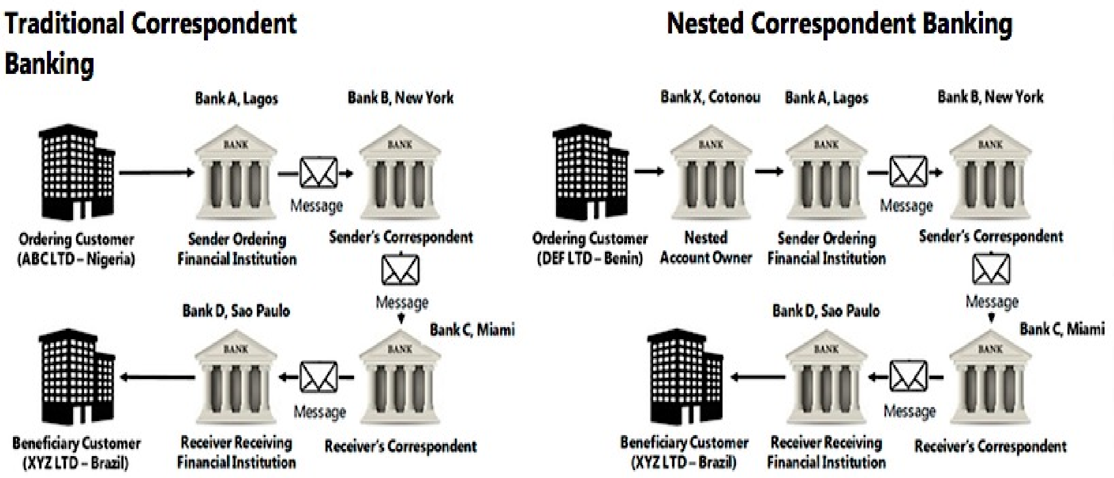
An empirical analysis on the decline of correspondent banking relationships is in line with the above study on American financial institutions' amounts outstanding as well as net risk transfers vis à vis some of their Caribbean counterparties. This is because it is expected that the perceived decline of correspondent banking relationships in the Caribbean as with the negative results provided by the Consolidated Banking Statistics are deeply interconnected with the rise of anti-money laundering and counter-terrorist financing compliance requirements. All of these within the eye of the financial de-risking phenomenon as well as the risk-based approach proposed by the Financial Action Task Force more than a decade ago.

To begin with, it is relevant at this introductory point to explain what correspondent banking is and how it works. In this sense, correspondent banking portrays an inter-bank arrangement in which one correspondent bank holds the deposits owned by other respondent banks in order for the correspondent to provide with payment and other financial services to that respondent institution (Committee on Payments and Market Infrastructures 2016). In specific, respondent banks would be required to open an account on their correspondent´s books for the exchange of certified interbank messages in order to settle and credit/debit those accounts (Ibid. 2016). This is one of the reasons why the

SWIFT system becomes relevant for both, the execution of those inter-bank transactions as well as for the proposed analysis of this section.

Correspondent banking relationships are particularly relevant for cross-border transactions. These are most of the time in favour of the usually smaller or more local respondent banks that execute third-party payments, trade finance, cash clearing, liquidity management, and short-term borrowing and investment services in another currency and jurisdiction (Committee on Payments and Market Infrastructures 2016; The Wolfsberg Group 2014). In other words, correspondent banking is essential for the international accessibility of financial institutions to foreign financial services and products that might not be available in these institutions' own jurisdictions (Committee on Payments and Market Infrastructures 2016).

Graph 1 from the International Monetary Fund (2016)[13] shows the work around correspondent banking in a simplified manner:



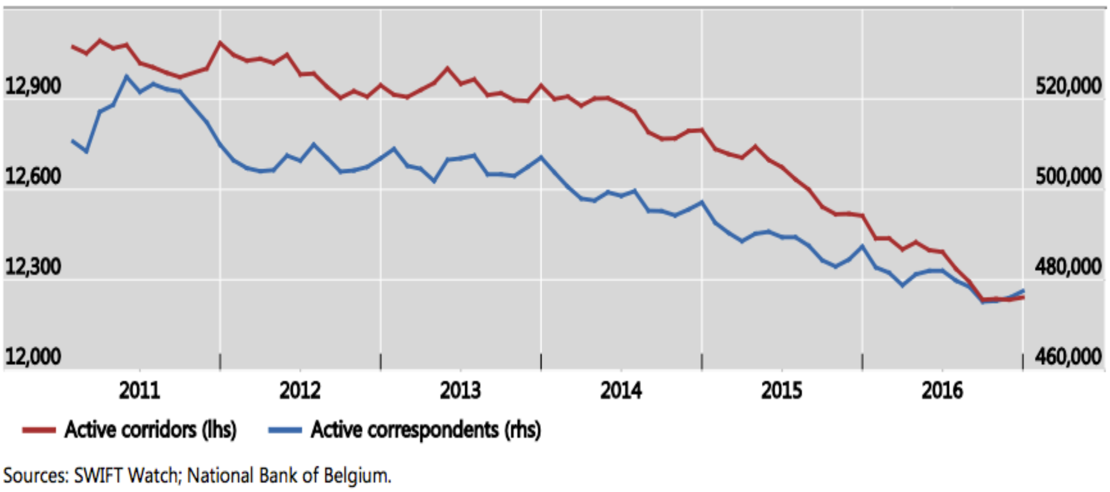
[13] https://www.imf.org/external/pubs/ft/sdn/2016/sdn1606.pdf

Within the above conceptual framework, the turn of the second decade of the 2000's had led the path for a steady decline on correspondent banking relations in several parts of the world. Particularly, after 2013 all regions in the world experienced a decline of their correspondent banking relations (Financial Stability Board 2017). It has been concluded that until 2016, the Caribbean as well as the small states of the Pacific (Melanesia, Micronesia and Polynesia) are the sub-regions that have been most affected with the highest rates of correspondent banking withdrawals portraying rates that almost reach the 10% level (Ibid. 2017). As such, the correspondent banking decline has also become an increasingly pertinent topic of discussion within the Small Island Developing States' (SIDS) academic literature (Briguglio 2018). Unsurprisingly, most of the providers of correspondent banking services are established in North America, Europe and East Asia, which gives way to think that the provision of correspondent banking services comes on a unilateral basis (Financial Stability Board 2017).

In perspective, the most common surveyed and cited reasons provided by major financial institutions on their withdrawal of correspondent relationships are on the scheme of profitability, perceived risk, and compliance (Committee on Payments and Market Infrastructures 2016; Financial Stability Board 2017; International Monetary Fund 2016; Starnes et al. 2017). The arguments around the decline of correspondent banking relations propose that insufficient volumes of business, inadequate or deficient respondent banks' risk and compliance assessment of their clients, and overall operation costs are all profoundly related with a perceived rise on anti-money laundering and counter-terrorist financing expectations and compliance costs (Committee on Payments and Market Infrastructures 2016; Financial Stability Board 2017). This factor would be interpreted as a driver for the decline of correspondent banking in the next chapter given the early empirical evidence provided in the present one.

The collection of monthly SWIFT data from 2011 until 2016 shows both a steady decline of active corridors through which at least a pair of countries have settled a transaction as well as a decline on the amount of active correspondent banks (Financial Stability Board 2017). However, it is relevant to bear in mind that SWIFT counts active correspondents in more than one corridor for several times (Ibid. 2017). Figure 8 shows that the decline on both corridors and active correspondent has become particularly relevant after 2014. In general, throughout the period from 2011 until 2016, it has been contemplated that 6.3% of corridors had been reduced and 6% of active correspondents had been diminished globally (Ibid. 2017). In terms of currency, the decline of correspondents using the U.S.D. and EURO has been the worst throughout the described period (Ibid. 2017). This is enacted by an overall reduction by 15% on both the U.S.D. and EURO (Ibid. 2017).

Figure 8: Number of Active Corridors and Active Correspondents per Month (Financial Stability Board 2017).



On the correspondent side, meaning the number of active correspondents, Oceania and Latin America and the Caribbean had been identified as the regions with the deepest decline on number of active correspondents with -12% and -8% respectively (Financial Stability Board 2017). Such deterioration is also present in the number of corridors. Oceania with 15% of decline while Latin America and the Caribbean with a 7% decline (Ibid. 2017). The actual number of received and sent SWIFT messages, in this context, makes emphasis on the reduction of the above described correspondent banking relations. Therefore, it is also relevant to quantify the fluctuations of SWIFT messages, specially in sub-regions such as the Caribbean.

The change of volume at both the sender and receiver side is graphically portrayed in figures 9 and 10. It becomes apparent that sent and received volume has decreased down to almost 10% in the Caribbean making it one of the worst affected sub-regions in relation to its financial market size. The worst years compounded for the Caribbean in terms of declining rates of sent/received volumes of SWIFT messages are 2014 and 2016 intrinsically related with the trends shown in figure 8.

Figure 9: Active Correspondent Sent Messages (Financial Stability Board 2017).

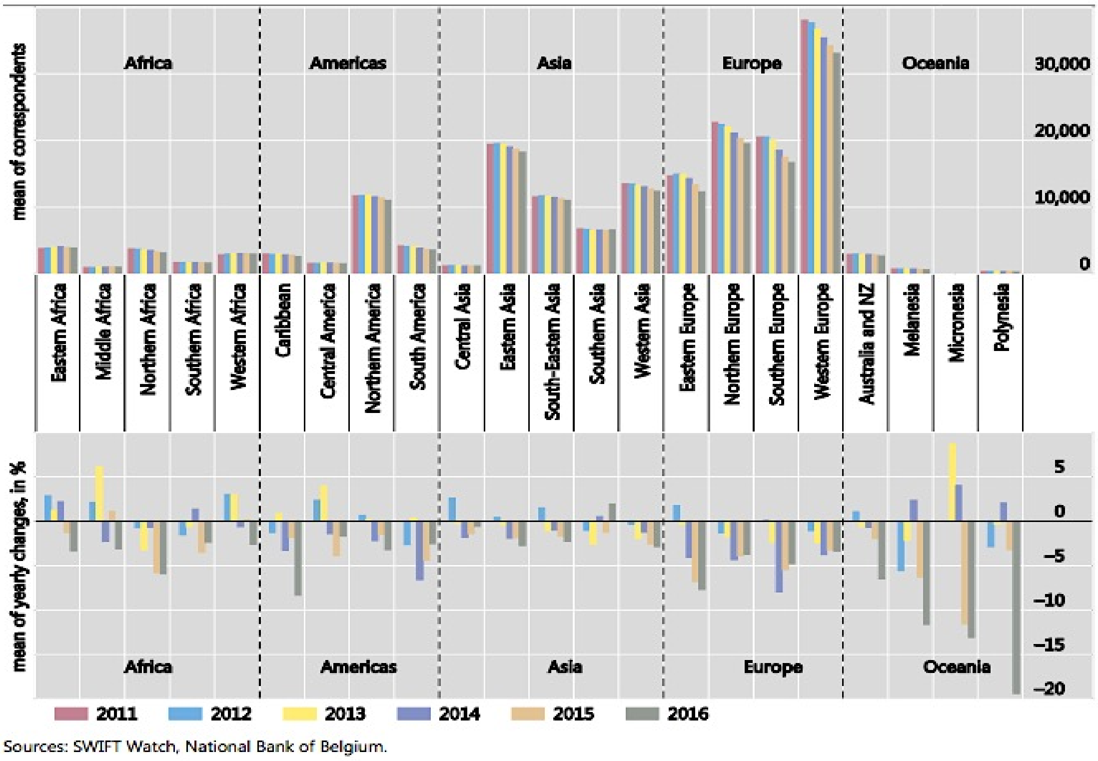
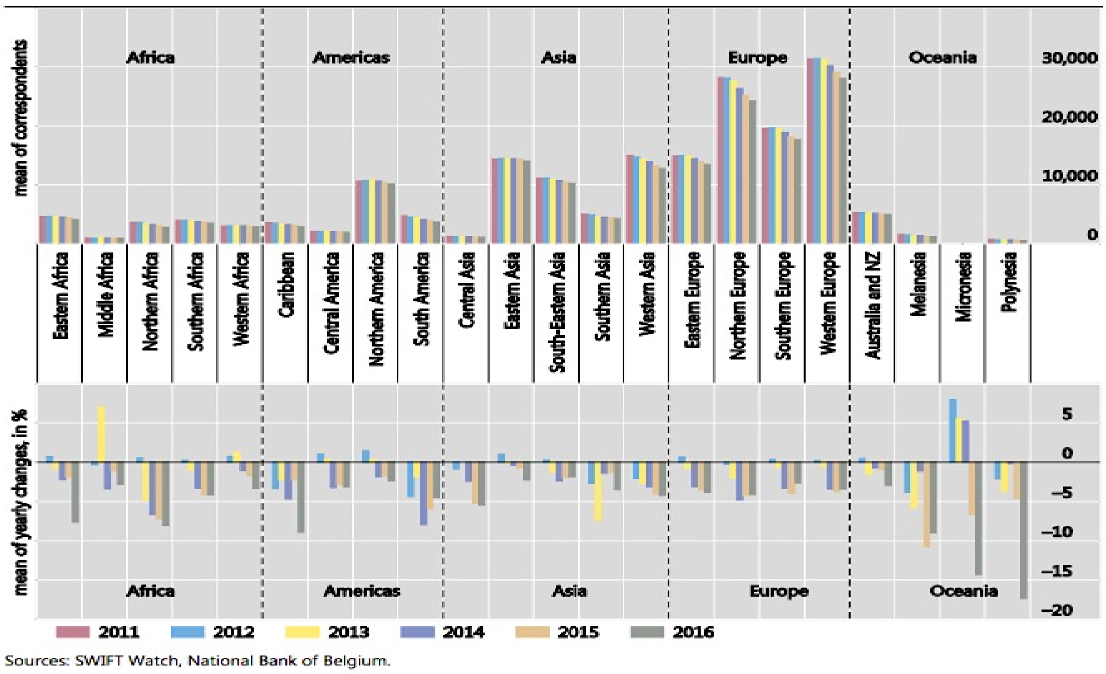


Figure 10: Active Correspondent Received Messages (Financial Stability Board 2017).



The specific quantification of SWIFT message flows presented in the above paragraph relies on two types of standardization. The first one, is the MT 103 that is known as a single customer credit transfer through which a financial institution instructs another one to transfer funds to a single customer (Financial Stability Board 2017). The second one, is the MT 202 which represents a general request to move funds within financial institutions without any particular underlying or single customer (Ibid. 2017). The introduced diversification is relevant because correspondent banks do not always have direct contact with the final recipient of the transfer, and instead, these institutions would rely on inter-bank relationships for the flow of such business. This is something that makes the decline of correspondent banking particularly challenging to analyse given the sometimes disregarded relationships that correspondent banks could have.

At the individual level, it has been identified that the estimated average of complete country exits by 150 major correspondents' banks have been on extreme basis from 90% to 100% in sanctioned jurisdictions such as Syria, Iran, Libya, Sudan, Korea D.P.R, Cuba, Venezuela, Iraq, Yemen, and Afghanistan (Financial Stability Board 2017). In the Caribbean case, the Bahamas, Barbados, Belize, Bermuda, Cayman Islands, and Turks and Caicos Islands had been predominantly affected by declining rates of the value of their SWIFT messages, the number of correspondent banking relationships as well as the rate of complete country exits by major financial institutions in the period from 2011 until 2016. Table 1 summarizes the findings.

Table 1: Country-Level Overview (Financial Stability Board 2017 sourced by SWIFT Watch and FSB-CBCG Survey).

JURISDICTION	SWIFT VOLUME	SWIFT VALUE	CORRESPONDENT BANKING RELATIONS	RESTRICTIONS	PERCENTAGE OF COUNTRY EXITS
BAHAMAS	23.8%	-38.5%	-15.1%	4	-8%
BARBADOS	13.4%	-50.8%	-13.6%	6	0%
BELIZE	-44.6%	-44.2%	-16.0%	1	-67%
BERMUDA	-4.9%	-11.7%	-28.9%	3	-20%
CAYMAN ISLANDS	20.1%	-31.0%	-9.9%	6	0%
TURKS AND CAICOS ISLANDS	9.7%	8.5%	-8.2%	4	0%

It is appreciated that at Table 1 Belize must be considered the most affected jurisdiction by all ascribed factors. Particularly for the line of analysis, the rate of exiting relationships with major financial institutions achieves a negative rate of 67%. Following are the jurisdictions of Bermuda and the Bahamas with negative rates of 20% and 8% respectively. Through this light, it is pertinent to say that the percentage of county exits does not only conceptualizes the whole de-risking phenomenon in a generic manner. In addition, the above mentioned factor also captures, up to some degree, the intrinsic risk perceptions and business models that major Western financial institutions have against certain jurisdictions in the Caribbean. This is synchronised by the fact that all jurisdictions in Table 1 have negative rates of correspondent banking relations not lower than 8%. An imminent decline on correspondent banking relations in the Caribbean.

Regarding the fluctuations around SWIFT messages and their value, it is relevant to analyse two factors: the adaptation process of respondent banks in face to these challenges and their ultimate operational as well as economic costs. In this sense, as correspondent banking relations continue declining, the value of the messages do the same almost in a double-parallel manner. In other words, since respondent banks need to change their correspondent arrangements, which most of the time results in more complex and expensive corridors, even the smaller transactions need to be flowing around the inter-bank system (Financial Stability Board 2017). As predicted, the value of such transactions is dramatically reduced by both the time that takes to operate it and the cost of such complicated operation. That might be one of the reasons why the rates on SWIFT value remains all negative (with the exception of the Turks and Caicos Islands) while the volume of such messages had actually increased for most of the jurisdictions.

As it stands now, this chapter has provided with the empirical fundamentals around the issue of credit exposures and the net risk transfers orchestrated by major American financial institutions. Additionally, the analysis over diminishing correspondent banking relations has joined in the analysis in order to introduce the phenomenon of de-risking. Through that empirical lens, it might become easier to grasp what de-risking is and is not when analysing it within the increase and institutionalization of anti-money laundering and counter-terrorist financing requirements.

SECTION III: OF UNINTENDED EFFECTS AND PERVERSED DICHOTOMIES.

The introduction of a risk-based approach enacted through the *Recommendations* of the Financial Action Task Force against money laundering and the financing of terrorism set the ground for a greater and *unintended* financial movement. In this sense, it is certain that by allowing for the standardization of anti-money laundering and counter-terrorist financing regulations, both regulators and financial institutions could identify more effectively any sort of risk in the above mentioned basis. That is why it is relevant to emphasise that money-laundering and terrorist financing are financial as well as non-financial risks. In specific, as money laundering is certainly detrimental for the tax collection and finances of a jurisdiction, such activities could also be widened through the scope of the financing of terrorism, which represents more of a political and societal risk. In other words, the term risk presented throughout this research should be interpreted as a deep relationship between money (finance) and politics (regulation) on the basis of global financial flows.

However remarkable the global standardization of anti-money laundering and counter-terrorist financing sounds to the ears of its relevant stakeholders, such an approach has also given free path to misinterpretations over financial counterparties and jurisdictions. The political endeavours of the Financial Action Task Force are not reduced to a few collection of reports nor to the institutionalization of the *40 + 9 Recommendations.* The FATF is in fact actively assessing the AML-CFT policies of a group of jurisdictions that are popularly regarded as “high-risk” or in the words of the FATF as “Non-Cooperative

Countries or Territories" (NCCTs)[14]. All of this assessment is publicized and enlisted through what is commonly known as the FATF's black and grey lists.

The FATF's blacklist contains two strands of identification. The first one could be considered as countries that represent a systemic risk for the international financial system. On this side, the FATF usually calls for preventive and counter-action from its member states against the identified jurisdictions in the form of economic sanctions or blockades. As of October, 2018 the two remaining countries on the "Call for Action" statement were the Democratic People's Republic of Korea (DPRK) and the Islamic Republic of Iran (FATF-GAFI.org)[15]. The second strand of the FATF's blacklist is on the basis of jurisdictions with strategic deficiencies on the enactment and application of AML-CFT policies, but that have committed with the FATF for the implementation of an action plan. The current list contains the following countries: The Bahamas, Botswana, Ethiopia, Ghana, Pakistan, Serbia, Sri Lanka, Syria, Trinidad and Tobago, Tunisia and Yemen (FATF-GAFI.org)[16]. Two other jurisdictions have graduated or successfully accomplished the FATF's imposed action plan in 2018. These were Iraq and Vanuatu.

Following the blacklisting purposes presented above, the FATF also reviews and enlists other jurisdictions on the basis of a grey list. This is presented as jurisdictions that have an action plan to tackle relatively minor deficiencies on

[14] http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/more/aboutthenon-cooperativecountriesandterritoriesncctinitiative.html?hf=10&b=0&s=desc(fatf_releasedate)
[15] http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/public-statement-june-2018.html
[16] http://www.fatf-gafi.org/publications/high-riskandnon-cooperativejurisdictions/documents/fatf-compliance-june-2018.html

their AML-CFT policies, but that are still considered as high-regulatory risk (Collin, Cook and Soramäki 2016). A total of 56 countries had been "greylisted" since 2010, most notably jurisdictions situated in Sub-Saharan Africa as well as in Latin America and the Caribbean (Ibid. 2016). Interestingly, the grey list appears to be the one that authorities and regulators residing in any of the FATF's 35 member states pay most of their attention and advise to their local financial institutions (Collin, Cook and Soramäki 2016; Farías and Arruda de Almeida 2014; Office of the Comptroller of the Currency 2002). As such, the continuation of the present chapter will deepen on the analysis of the specific role that the FATF's greylisting in addition to other "name and shame" mechanisms had had in the negative regulatory risk assessment portrayed through fewer cross-border (SWIFT) payments as well as increased precautionary financial measures from the part of financial institutions.

Notably, few academic inquiries had been written on the relationship between being exposed as a non-compliant jurisdiction by the FATF with declining cross-border (SWIFT) transactions projected through less correspondent banking relationships and greater financial protectionism. Therefore, it has become evident that the whole phenomenon of financial de-risking is under-investigated. Despite few evidence, empirical trajectories on the above mentioned relationship had been initiated by authors such as Collin, Cook and Soramäki (2016) or Farías and Arruda de Almeida (2014). Official accounts are beginning to appear specifically from the World Bank and its subsidiary, the International Financial Corporation, as well as the Central Banks and financial institutions of small islands states throughout the Caribbean and part of Latin America.

The empirical results presented throughout this chapter will be analysed in conjunction with the ones introduced by Collin, Cook and Soramäki (2016) and Farías and Arruda de Almeida (2014) on their own academic work. This is with the purpose to highlight the relationship between being exposed in the FATF's grey list with declining financial accessibility through cross-border (SWIFT) payments between the non-listed and listed jurisdictions. All of these dynamics known as de-risking in the context of this paper accelerated by the rise of AML-CFT regulations.

As grey listing has already been explained, it is pertinent at this stage to make an economic point about its configuration. It has been encountered that the probability of being grey listed by the FATF increases with the target jurisdiction´s income (Collin, Cook and Soramäki 2016). In this sense, as income remains below U.S.D 20,000.00 on GDP per capita terms the chances of getting under the FATF´s eyes increases by 40 percent (Ibid. 2016). It is not surprise then, that a vast amount of grey listed jurisdictions are either emerging or developing markets. In addition, that is also a factor for consideration in which this paper has relied in order to choose selected jurisdictions in the Caribbean. Moving forward with the analysis, empirical evidence has been found in the sense that a reduction by up to 10% in the number of received payments is present in grey listed countries (Ibid. 2016). In close relation, it has been found that in Latin America and the Caribbean, jurisdictions tend to lose as much as 20% of their Foreign Direct Investment payments if these are black or grey listed (Farías and Arruda de Almeida 2014).

In continuation, the fact of being badly publicised as a non-AML-CFT compliant territory through a FATF's black or grey list have deeper economic effects than usually accounted for (Collin, Cook and Soramäki 2016; Farías and Arruda de Almeida 2014). A simple explanation relies on what has been said at the beginning of the above paragraph. The vast majority of countries enlisted by the FATF are more likely to be economically and institutionally poor and inefficient. Through this light, in the case of the Caribbean and to a lesser extent of Latin America, the investment and the FDI ratios to GDP had been deeply distorted over time (Farías and Arruda de Almeida 2014). Specifically, the ratio of capital over GDP in Latin America and the Caribbean has been negatively distorted by at least 3 percent (Ibid. 2014). Such effects are in accordance with the negative net risk transfers in the context of the Caribbean presented in Chapter two of this project. Accumulated capital and investment has not only been reduced by institutionalized portrayals of non-compliance in the Caribbean in the last two decades. But as demonstrated, it has consistently escaped these island territories leaving a gap on economic development for the long-term (Collin, Cook and Soramäki 2016; Farías and Arruda de Almeida 2014).

With what has been introduced above, it is not difficult to perceive the negative economic effects that de-risking has on small island economies within the Caribbean. In depth, there are two main obstacles that have become the source of agony for policy-makers in this part of the world given the decline of correspondent banking relationships as well as of cross-border payments possibilities. These two main challenging effects are present on an increasingly difficult to finance trade through the issuing of trade finance instruments as well as increased economic and political challenges to access capital and investment in the context of small market economies and their embedded local corporations and individuals (Starnes et al. 2017). All of these preoccupations seem to be ironically sourced from Caribbean economies that had been historically prompted, if not forced, to have excessively open and liberalized markets in order to trade with former colonizers and nearby economic superpowers (Haberly and Wójcik 2015; Lee and Smith 2010). Such relationships will be expanded in the second section of this chapter, but first an analysis of the two set of *unintended* effects faced by the Caribbean economies in the context of increased AML-CFT regulations will follow.

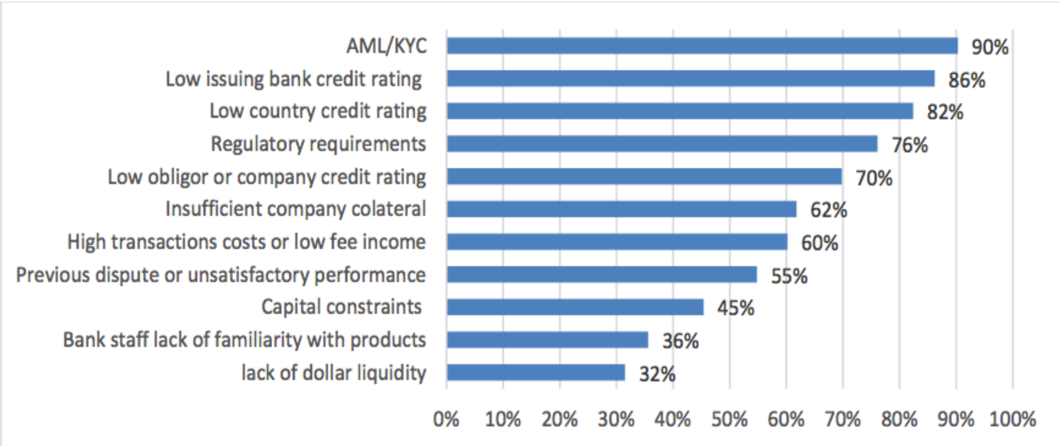
Multiple institutional studies on the phenomenon of de-risking have found worrisome patterns of de-linkage from the world's main financial markets in the Caribbean (Erbenová et al. 2016; Starnes et al. 2017). In 2016, one of the most prominent studies conducted by the International Monetary Fund led the path to acknowledge that most of the financial institutions founded and residing in The Bahamas, Guyana, Haiti, Jamaica and Trinidad and Tobago have been exposed to a great number of reductions in their correspondent banking relationships (Erbenová et al. 2016). Not surprisingly, the name of the above mentioned jurisdictions is also to be found in the grey list enacted by the FATF. Following this line of thinking, one specific case sets the mark of the whole de-risking buzz in the Caribbean. In Belize, only two of its banks have managed to maintain correspondence with full banking services in the United States (Ibid. 2016). Such dramatic decline on accessibility to financial communicative systems as well as products are vividly surveyed and experienced in the framework of trade finance.

The International Chamber of Commerce survey of 2015 revealed that about two-thirds of the surveyed banks alleged that their cost of funds and liquidity had been diminished given the introduction of Basel III regulations on stricter AML-CFT conditions (International Chamber of Commerce 2015)[17]. Seven in ten of the surveyed participants claimed that the implementation of tougher AML-CFT regulations was being translated in considerably less support for trade transactions (Ibid. 2015). In fact, 93% of respondents related the increased financial and institutional costs of keeping pace with AML-CFT regulations to be one of the strongest impediments to facilitate trade finance services to Latin American and the Caribbean (Ibid. 2015).

Correspondent banking relationships are primordial in order for trade finance to take onto effect. This is because trade finance instruments are based on existing credit relationships between counterparty banks (Starnes et al. 2017). In this sense, buyers and sellers get into a commercial relationship intermediated by financial institutions in order to tackle real or perceived risks about the ability to pay by the counterparty, its financial stability, and the macroeconomic position of the jurisdiction in which trade is taking place. In most of the cases for the goods to be shipped, the confirming (or correspondent) bank must be willing to take payment risk of the local bank of the seller (Ibid. 2017). Even though these are usually short-term financial obligations, the accumulated capital and AML-CFT constraints presented in the above paragraph have pressured the disappearance of major international banks as confirming parties in emerging and developing markets such as in Latin American and the Caribbean (Ibid. 2017). Figure 11 summarizes the surveyed findings proposed by the International Chamber of Commerce (2015) and Starnes et al. 2017.

[17] https://cdn.iccwbo.org/content/uploads/sites/3/2015/10/ICC-Global-Trade-and-Finance-Survey-2015.pdf

Figure 11: Trade Finance Impediments Sourced by Banks (Starnes et al. 2017)



Source: ICC Global Survey on Trade Finance, 2015.

Declining inter-banking relationships within the context of the provision of trade finance products appears to be particularly disruptive to smaller and local banks. The World Bank has estimated that close to 50% of surveyed banks assured that their trade finance services had been negatively affected by declining correspondent banking relationships (Starnes et al. 2017). In this sense, it has been noted and perhaps it is one of the most relevant conclusions to take from the ICC's 2015 report, that the majority of surveyed banks have recognized Small and Medium-Sized Enterprises as the most affected by the decline in the provision of trade finance solutions in Latin America and the Caribbean (International Chamber of Commerce 2015). Such a statement drives us to connect the present analysis to the second negative effect of de-risking. That is, the abatement on accessibility to capital and investment or financing opportunities in small market economies such it is the case of the island states in the Caribbean.

At the macroeconomic level, the Caribbean is one of the economic regions in the world that relies the most on cross-border funding in order to finance their trade activities (Starnes et al. 2017). On average, 94% of the Caribbean states' GDP relies on export-oriented activities on trade and on the imports of oil and its derivatives (Boyce and Kendall 2016). At the microeconomic level, the decline of correspondent banking relationships and overall risk appetite from major international banks in the Caribbean has prompted a disproportionate negative effect on corporate and individual customers with higher regulatory (AML-CFT) risks (Starnes et al. 2017). In this light, it has been determined that Small and Medium-Sized Enterprises (SMEs) tend to be de-risked faster than bigger corporates within the same productive sector (Ibid. 2017). As SMEs find it more difficult to finance their trade activities and their accessibility with major international markets, these type of firms will be probably facing capital constraints that would undermine their sole existence (Ibid. 2017). Remarkably, it has been calculated that SMEs in emerging and developing markets such as in the Caribbean could contribute to up to 60% of total employment as well as 40% of GDP (Ibid. 2017).

In sum and in the specifics of the Caribbean case study, the reduction of correspondent banking relationships, as it has been quantitatively presented in chapter two and qualitatively in the present section, has raised the cost of finance and capital for SMEs by losing immediate access to credit and trade confirmation from major North American exporters (Boyce and Kendall 2016; Erbenová et al. 2016; Starnes et al. 2017). As straight-forward as the results presented above appeared to be, these are not to be taken as such. The specific case of the Caribbean presents us with more historical and institutional complexities that are not to be reduced to a de-risking fetish.

One of the like resides on the drivers for certain jurisdictions to not comply or do so minimally with the FATF's AML-CFT standards. Farías and Arruda de Almeida (2014) have determined that until being black or grey-listed by the FATF, the ratios of portfolio and FDI over GDP in most of the *non-compliant* jurisdictions were almost three times higher as those complying with AML-CFT regulations. Also, it has been encountered that CARICOM (Caribbean Community) countries' domestic credit over GDP was on average 30% higher before being black or grey listed by the FATF (Ibid. 2014). Both of these results, lead the way to believe that the flow of illicit money as well as the status of Offshore-Financial Centre could play a portrayal to not comply or do so minimally with the FATF's AML-CFT regulations (Ibid. 2014). In this sense, what has been predominantly missing in the current literature regarding financial de-risking and the rise of AML-CFT regulations is an analysis on how both phenomena are at play within the framework of an Offshore-Financial Centre. It might be regarded that such an analysis is out of scope in this research project, but it is not.

If one talks about the financial dynamics within the Caribbean community, one is set to find a double-paradox. On the one hand, the real and formal economy is facing financing and accessibility challenges due to lower correspondent banking relationships and an overall decline of capital and investment. On the other hand, a Caribbean jurisdiction such as the Cayman Islands is popularly considered as an Offshore-Financial Centre where illicit or secretive flows of money arrive and sometimes stay as non-productive investments, or these simply scape tax or other type of regulations into investments in the world's major financial centres (Farías and Arruda de Almeida 2014). The remaining section of this chapter will initiate a missing discussion in the academic literature over the conflicted case of the Cayman Islands as the third's biggest Offshore-Financial Centre (OFC) and its trajectory of being first a FATF's black-listed jurisdiction in the year 2000 to become a dubious financial and economic example to follow within its Caribbean community. The following is more of an historical and politico-economic analysis in the above presented paradox, rather than an accumulation of empirical evidence.

CASE-STUDY: CAYMAN ISLANDS, ON THE EDGE OF FINANCIAL POWER AND INSTITIONAL BLOCKADE.

The Cayman Islands were one of the inaugurating jurisdictions of the FATF's first-conceived black list of Non-Cooperative Countries or Territories in the year 2000. Shortly after its introduction, in June 2001, this jurisdiction was taken out of such list in allegiance to deep public and bilateral commitments to improve its AML-CFT regulatory framework by partnering with both the FATF and the Organization for Economic Co-operation and Development (OECD) (Cayman Islands Monetary Authority 2007)[18].

Interestingly, since the beginning of the new millennium, the Cayman Islands were witness of an accelerated development of off-shore financial services to American, British and to a lesser extent, Japanese counterparties (Fichtner 2016). Thus, the Cayman are now regarded as one of the world's biggest and most prominent off-shore conduits for major financial institutions by enabling them a reduction of taxes and of on-shore financial regulation on their services (Ibid. 2016). Illicit financial flows appeared of non-importance for the Cayman Islands' financial sphere. Conversely, this jurisdiction has been successful in

[18] https://www.bis.org/review/r070627f.pdf

adapting an inherited law establishment from the British with sophisticated ways of regulatory reactionary movements in the midst of the FATF's prominence (Fichtner 2016; Hampton and Christensen 2011).

Until now, this research has provided with a focus on the analysis of the relationship between the rise of international AML-CFT regulations with declining financial accessibility and flows in the Caribbean. In fact, it comes pertinent at this time to highlight that in this part of the world the export of commodities could conform between 70 to 96 percent of the local GDP (Heger et al. in McGuillivray, Naudéand and Santos-Paulino 2010). Such composition of the economy would tell a great level of volatility, and above all, a great level of dependence on international markets (Ibid. 2010). In this case, it is usually demonstrated that the small islands in the Caribbean are exponentially and negatively exposed to terms of trade fluctuations given their little influence on the international market pricing (Santos-Paulino 2010). Through this line of thinking, another relevant source of specialization that was developed in specific jurisdictions in the Caribbean has been the provision of off-shore financial services.

With the massive liberalization that took place in the global financial markets in the 1980's, the formulations of niche or highly specialized off-shore financial centres came as part of the development plan of some small islands in the Caribbean (Vlcek 2008). In fact, the establishment of the above mentioned services was prompted and to some extend availed by the United Kingdom through its Overseas Dependencies, particularly in the Cayman Islands, the Bahamas and the Turks and Caicos Islands (Ibid. 2008). At the political and popular sphere, the provision of financial services within a context of secrecy and lax taxation began to conform part of the identity of these islands.

As a “regulatory tsunami” came throughout the 1990’s and 2000’s from the OECD and the FATF, power asymmetries were clearly visible on who mandates and proposes standards against the reproduction of money-laundering and terrorist-financing (Vlcek 2008). The great majority of Caribbean jurisdictions were independent and consolidated states at the time of the regulatory shock, which accelerated the feeling of national sovereignty against intervention as well as resilience against powerful mandates (Baldacchino and Bertram 2009; Vlcek 2008). In the particular case of the Cayman Islands, as this territory maintained its status as a Crown Dependency, the dynamics behind anti-money laundering and counter-terrorist financing were different in the sense that these were not stringent nor overwhelming as its other Caribbean peers could tell.

The impetus over the already described nationalistic sentiment as well as the regulatory overflow coming from the FATF and its member states was not only based on the fact that money laundering was being consolidated as a mechanism to conceal capital flight out of Russia at the end of the 1990’s (Vlcek 2008). In addition, and despite the evidence telling that most of the illegal capital flows were being canalized by major international banks in New York, all of the FATF regulations were particularly targeted to developing off-shore financial centres in the Caribbean, the Pacific and the Mediterranean (Vlcek 2008). As regulatory costs exponentially raised in the majority of these jurisdictions, most of their off-shore financial activities were diminished and erased from their public books (Ibid. 2008). Conversely, the Cayman Islands remained partly untouched by the regulatory glitz at this time. As Fichtner demonstrates three main off-shore and niche financial services were on the rise in Cayman since the 2000’s: off-shore banking, Greenfield FDI, and the channelling of portfolio investment through increased hedge fund activities (Fichtner 2008).

The three niche financial services listed above represent the status of the Cayman Islands only as a conduit, and not as a main investor or investment recipient in the global financial system. As an off-shore banking centre, the Cayman Islands receive overnight deposits by U.S. and to a lesser extent, Japanese parent accounts installed in their Cayman branches (Klein in Fichtner 2008). These flows of money do not stay in the jurisdiction as a form of lending to other banks, but instead, these funds avoid U.S. reserve requirements and other regulatory bugs by investing them mainly on hedge funds and other types of financial investment tools (Fichtner 2008).

Given the extremely small size of the local Cayman economy, the flows of inward and outward direct investment are a pure reflection of what was analysed on chapter two in regards to net risk transfers. In this sense, it is said that the Cayman Islands serve as an "entrepôt" jurisdiction whereby more than half of the inward flows of direct investment are re-directed to either its source of origin or to another major economy (Fichtner 2008). Developed economies such as the United States, the Netherlands, or Luxembourg are senders and receivers of these "investment" funds from the Cayman Islands that most of the time enter this jurisdiction with a different name and purpose from its exiting form (Ibid. 2008). These are, in many cases, conduits of hedge fund investment.

The Cayman Islands has established one of the biggest hedge fund industry in the world. All of these companies are legally settled in Cayman and enable portfolio investment to take on a more secretive form in order to pay less taxes and to be protected by a sophisticated law system inherited from the British (Fichtner 2008). Through this manner, 75% of portfolio investments return to the United States and the rest is distributed throughout Europe (mainly into the

United Kingdom) (Ibid. 2008). As such, an imaginary triangle of investment relationships is formed between the United States, the United Kingdom, and the connecting node being the Cayman Islands.

On this angle, the political mandate of the U.K. over the Cayman Islands brings a sense of stability and protection (Ibid. 2008). To add purpose to such political protectionism, the City of London has in fact overshot the growth of the Cayman Islands as an off-shore financial centre in order to intermediate the City's business with the U.S. and other major counterparties (Ibid. 2008). Given such relationship and due to its geographical proximity to the United States, the Cayman Islands had become the preferred securities and asset holders of U.S. financial institutions as well as corporates (Ibid. 2008).

However, one must not be confused as to signalled the Cayman Islands as another British colony that serves the financial and investment needs of the Crown. One might otherwise say that the Cayman Islands, in view of the evidence provided in the present and former chapter of this research, has developed its law system in line with the British one in order to become a financial colony of North American counterparties. Such financial relationships cater the American taxation and other regulatory interests while superficially promoting and complying with the FATF's AML-CFT mandate. It might be the case that the risk-based approach is wrongly directed towards entire jurisdictions and simple transactions, rather than being applied to the type of investments and counterparties explained throughout this section.

CONCLUSIONS.

The Cayman Islands' economy and financial structure is an incongruent picture of richness and scarcity. This is in fact the case in most of the Small Islands Developing States of the Caribbean that had been analysed throughout this paper. Off-shore banking and investment services have not been on a decline as the OECD and FATF tend to brag about. Such inflows of secretive and sometime dubious financial and investment flows are particularly adamant of some of the islands in the Caribbean. However, as institutional and political efforts are on the rise in order to prevent money laundering and the financing of terrorist activities, it appears to be that everything but the demise of off-shore financial centres acts as a consequence of such regulatory movements. It is then palpable that a double-discourse of compliance, but also of flexibility is present at the policy-making process in the Caribbean, and in the Cayman Islands in specific. This is in conjunction with the regulatory grounds of the FATF within their developed economies membership club.

Flexibility is present through the exponential increase of secretive financial flows and tax-free investment services that this research had de-covered in the Cayman Islands. Compliance, on the other side of the coin, comes through institutionalized measure in the supposedly fight against money laundering and the financing of terrorism. However, the imposition of AML-CFT standardized regulations is more of a top-down business whereby the usual economic and political powers of the world have more of a say around such financial issues. The core of the inquiry relies on the evidence that it is indeed true that major global financial institutions prefer to cut relationships and the provision of many, if not all, of their financial services to jurisdictions deemed non-compliant. The mechanism of knowledge that allows for interpretations of who comply and who does not is through the black and grey listing of entire jurisdictions availed by the FATF. Such information in addition to recurrent misconceptions from financial institutions on local as well as international financial policies and regulations have prompted a grave economic as well as communicative effect on the daily-business of trade finance and financing for Small and Medium-Sized Enterprises in Small Islands Developing States.

SIDS in the Caribbean, as has been recurrently prompted and even theorized throughout this research, are immensely reliant on international commerce and capital accessibility for their local businesses. In this sense, it is relevant to emphasise that becoming an off-shore financial centre as the Cayman Islands might be beneficial to a few number of locals and to a disproportionately greater number of international businesses and wealthy individuals. Through this view, the empirical evidence shown in chapter two is the image that replaces a few hundred words on the complex financial dynamics around regulation, risk-taking and accessibility.

As net risk transfers have indicated, major international financial institutions keep doing business with the Caribbean in an imperceptible basis on economic terms. The fact that outward risks is predominantly greater than inward risk indicates the status of the selected Caribbean economies as an "entrepôt" or conduit of financial as well as investment flows that will have a real economic effect on one or many of the FATF's member states. As such, the decline of correspondent banking relationships in the Caribbean reinforces this idea. This is because net risk transfers and the conduits of financial or investment flows are usually made within the same financial institution that origins the business.

Conversely, correspondent banking relations highlight a real economic effect on how money moves and its underlying purpose. Therefore, as fewer international banks are interested in a long-term relationship with local and regional ones in the Caribbean, accessibility to financial products, capital and communication with the world's major markets becomes particularly difficult for local businesses and individuals. Thus, a great disruption and underdevelopment on these already fragile island economies is permeated.

It might be true that a greater institutional financial and risk-compliance movement could prevent the spreading of terrorism and deter the flows of illicit money. However, the evidence enacted throughout this paper shows that as long as institutions such as the FATF or the OECD turn a blind eye on the financial wrong doing of their member states by means of good wording and legislative adaptability, AML-CFT global measures would be useless and used as the underlying discourse to prevent unprofitable business and costs in several of the states in the Caribbean.

Technology as it has been insinuated at the beginning of this project could become part of the solution to the above mentioned issue. Distributed Ledger technologies such the use of blockchain are currently being tested and cooperated through major international banks and financial regulators. A specific example comes by the name of the R3-Corda project that allows the use of blockchain capabilities in order to share real-time information between financial institutions and local as well as international regulators on the underlying dynamics of these institutions' transactions, customers, correspondents and even on their correspondent's customers. The project is in an early-stage of development, which could lead imagination to be blown away. However, the initiative counts as a precedent of something that is still missing between all the financial stakeholders in a relationship. That is, real-time communication and assessment of what is excessive financial and non-financial risk within the context of a transaction, and what is a simple misconception regarding the deal's counterparty.

On the academic side, one could say that there is an immense gap on the research around off-shore financial centres in the Caribbean. In this sense, few analyses had contemplated their stakeholders' dynamics, their main beneficiaries and how such conduits of money are in fact affecting the real economy through decreased accessibility and financial opportunities to local businesses and individuals. Such interplay could be a start for future and relevant research. However, at the time of writing and at the end of this project, one message is clear and should be proposed. The relationship between finance and economic as well as social development should not be dismissed. It is a relevant one that depicts the complicated and sometimes corrupted interpolations that financial institutions have over emerging and developing economies. Something that is not written in any policy-paper, something that is not loudly spoken in any political nor academic circle, but something that prevents individuals in volatile economies to drive through fairer and more promising life's opportunities. This paper has been an echo of the persistent inequalities and injustices of the global financial and political system through the discourse for safer and more efficient international financial flows.

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