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Abstract

This study explored the ripple effect and consequences of correspondent banking de-risking on global financial inclusion and stability, with a specific focus on evidence from Europe. Driven primarily by increased compliance requirements and the need to mitigate risks associated with anti-money laundering and combating the financing of terrorism regulations, de-risking led to the termination of correspondent banking relationships with various countries and financial institutions. The research aimed to understand the implications of this phenomenon on financial integration, access to essential financial services, and the exacerbation of economic disparities among different regions and demographic groups in Europe. A descriptive research design approach was employed, mainly quantitative analysis of CBR data and regulatory changes. The findings demonstrated that de-risking had a significant negative impact on financial inclusion and stability, particularly for small and medium-sized enterprises, non-profit organizations, and marginalized communities. Moreover, the termination of CBRs disrupted the flow of remittances, trade finance, and development aid, and led to an increased reliance on less-regulated, informal channels, which in turn undermined the global AML/CFT regime and exacerbated financial crime and systemic risks. Based on these findings, the study recommended enhancing collaboration and coordination among regulatory authorities, financial institutions, and affected stakeholders to develop a harmonized regulatory framework across European countries, implement a risk-based approach, and establish a centralized information-sharing platform. Additionally, targeted capacity-building efforts, exploration of innovative financial solutions, and the development of financial inclusion strategies prioritizing the needs of the most vulnerable segments of the population were recommended to counteract the negative effects of de-risking and promote financial inclusion and stability in Europe.

Keywords: *Correspondent banking de-risking, financial inclusion, global financial stability, anti-money laundering, combating the financing of terrorism*

1.0 Introduction

The ripple effect of correspondent banking de-risking has become a growing concern for financial inclusion and global stability, particularly in the aftermath of the global financial crisis. The de-risking trend, primarily driven by increased compliance requirements and the need to mitigate risks associated with anti-money laundering (AML) and combating the financing of terrorism (CFT) regulations, has led to the termination of correspondent banking relationships (CBRs) with various countries and financial institutions (Economides et al., 2019). This phenomenon has resulted in reduced access to cross-border financial services, particularly in regions with weaker financial systems, further exacerbating economic disparities and hindering progress towards financial inclusion (McCauley, 2018).

De-risking can contribute to global financial instability by restricting access to essential financial services and impeding the flow of remittances, trade finance, and development aid (McCauley, 2018). When financial institutions withdraw from certain markets, the affected countries or institutions may resort to less-regulated, informal channels, which can undermine the global AML/CFT regime and potentially exacerbate financial crime and systemic risks (Economides et al., 2019). Moreover, the termination of CBRs can disproportionately affect small and medium-sized enterprises, non-profit organizations, and marginalized communities, exacerbating the vulnerabilities of these segments of the population and undermining efforts to reduce poverty and foster sustainable economic growth (Cecchetti & Schoenholtz, 2020).

The ongoing dialogue on the consequences of correspondent banking de-risking highlights the need for a comprehensive, coordinated approach to address the negative repercussions on financial inclusion and stability. Policymakers, regulators, and financial institutions should work together to develop targeted strategies and regulatory frameworks that balance the need for stringent compliance measures with the importance of maintaining access to essential financial services for all segments of the population (Cecchetti & Schoenholtz, 2020). By doing so, it will be possible to mitigate the ripple effect of de-risking and foster a more inclusive, stable global financial system.

Scarcity of resources is the driver of international trade; its roots can be traced to earlier civilizations who used barter-trade, this medium of exchange evolved to the use of precious metal, money, cheques, bank drafts and later on electronic money. The above medium of exchange has been a precursor to modern day banking. Bank drafts set the table for the development of correspondent banking due to inherent risks, i.e. liquidity risk especially large payments exacerbated by absence of efficient settlement mechanisms between paying and receiving bank, delay in payment days and risk of default by paying banks. These weaknesses led to the growth of loosely held correspondent banks through the advent of local clearinghouses for banks in Canada and the United Kingdom. For American banks, the regulator (National Banking system), barred individual states from establishing local clearinghouses, they however, approved banks in the state of New York (NY) to establish a clearinghouse for all banks in the USA.

Apart from clearing, the banks provided overnight loans as a solution to delayed payments occasioned by physical transportation of drafts. This age-old relationship was the foundation for control of global correspondent banking by NY based banks; equally, European and Japanese banks set office in New York so that they could also clear dollars without going through banks in NY. To solidify their influence, NY based banks in 1853, registered the Clearing House Payments Company LLC (CHPC); this organization controls the global payments infrastructure. CHPC and the Federal Reserve (USA's financial regulator), control international correspondent banking and consequently Financial Inclusion and Stability. Pertaining to the same and according to SWIFT, 2015, 51.9% of global payments were in dollars, meaning, more than half of global payments go through NY for clearing. This dominance, gives the Federal Reserve and the CHPC, power to de-risk banks without recourse, or may be the CBR's aim using their power of unplug, is to turn on the heat on the respondents, figuratively, so that they can remove their jacket.

The Financial Stability Board (FSB) conducted a study examining the decline in correspondent banking relationships and its impact on global financial stability (FSB, 2019). The FSB found that the reduction in correspondent relationships can lead to concentration risk, as banks become more reliant on a smaller number of counterparties, increasing the potential for systemic risk (FSB, 2019). This concentration of risk can make the financial system more vulnerable to shocks and reduce overall financial stability. The decline in correspondent banking relationships has also been found to impact financial inclusion. According to a report by the International Monetary Fund (IMF), de-risking has led to the exclusion of certain customer segments from the formal financial system, including money service businesses, non-profit organizations, and politically exposed persons (IMF, 2020). These populations may be disproportionately affected by de-risking measures, as they rely on financial services for remittances, welfare payments, and other essential transactions (IMF, 2020).

De-risking has also been found to influence the flow of remittances, which are crucial for supporting financial inclusion and economic development in many developing countries. A study by the European Parliament's Policy Department for Economic, Scientific, and Quality of Life Policies examined the relationship between de-risking and financial inclusion in Europe, with a focus on the impact on remittance flows (García-Herrero & Ribakova, 2019). The study found that de-risking could lead to reduced access to remittance services and higher costs for migrants, who often rely on these services to send money back to their home countries (García-Herrero & Ribakova, 2019).

In addition to remittance flows, de-risking has also been found to impact non-profit organizations (NPOs). NPOs are often disproportionately affected by de-risking measures due to concerns about money laundering and terrorist financing (Goredema, 2019). The closure of NPOs' bank accounts can hinder their ability to carry out crucial humanitarian and development work, which can have significant consequences for the communities they serve, as well as broader implications for financial inclusion and stability (Goredema, 2019).

To address the negative consequences of de-risking, various stakeholders have advocated for the development of innovative solutions. For example, the IMF has highlighted the potential of fintech to help counter the effects of de-risking by providing alternative channels for remittance flows and promoting financial inclusion (IMF, 2020). By leveraging digital technologies, financial institutions may be able to better manage risk while still providing essential services to higher-risk customers (IMF, 2020).

Policymakers and regulators have also taken steps to address the consequences of de-risking. For instance, the European Banking Authority (EBA) has emphasized the need for a balanced approach to de-risking that considers both the risks and benefits associated with providing services to higher-risk customers (EBA, 2019). By implementing overly stringent de-risking measures, financial institutions may inadvertently exclude legitimate customers from accessing necessary financial services, contributing to financial exclusion and potential social and economic instability (EBA, 2019).

The European Banking Authority (EBA) has also explored the effects of de-risking on financial inclusion in Europe. In their opinion paper, the EBA emphasized the need for a balanced approach to de-risking that considers both the risks and benefits associated with providing services to higher-risk customers (EBA, 2019). By implementing overly stringent de-risking measures, financial institutions may inadvertently exclude legitimate customers from accessing necessary financial services, contributing to financial exclusion and potential social and economic instability (EBA, 2019).

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The impact of de-risking on non-profit organizations (NPOs) has also been examined, as these organizations are often disproportionately affected by de-risking measures due to concerns about money laundering and terrorist financing (Goredema, 2019). The closure of NPOs' bank accounts can hinder their ability to carry out crucial humanitarian and development work, which can have significant consequences for the communities they serve, as well as broader implications for financial inclusion and stability (Goredema, 2019).

In response to the negative consequences of de-risking, various stakeholders have advocated for the development of innovative solutions to address these challenges. For example, the International Monetary Fund (IMF) has highlighted the potential of fintech to help counter the effects of de-risking by providing alternative channels for remittance flows and promoting financial inclusion (IMF, 2020). By leveraging digital technologies, financial institutions may be able to better manage risk while still providing essential services to higher-risk customers (IMF, 2020).

Furthermore, the World Bank has called for a more coordinated international approach to addressing de-risking, emphasizing the need for greater cooperation between governments, regulators, and financial institutions (World Bank, 2020). This collaboration could include the sharing of best practices, the development of common risk assessment frameworks, and the promotion of regulatory clarity to help financial institutions better navigate the complex landscape of correspondent banking (World Bank, 2020).

1.1 Research Problem

The ongoing phenomenon of correspondent banking de-risking has raised significant concerns within the global financial landscape, particularly in relation to financial inclusion and stability. This de-risking trend, primarily driven by increased compliance requirements and the need to

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mitigate risks associated with anti-money laundering (AML) and combating the financing of terrorism (CFT) regulations, has led to the termination of correspondent banking relationships (CBRs) with various countries and financial institutions (Economides, Guesnerie, & Stiglitz, 2019). In Europe, this growing issue threatens to undermine financial integration, restrict access to essential financial services, and exacerbate economic disparities among different regions and demographic groups (Cecchetti & Schoenholtz, 2020).

As a result, there was a pressing need to investigate the ripple effect of correspondent banking de-risking on financial inclusion and stability in Europe. The consequences of this trend could potentially hinder the progress made towards achieving a more inclusive and stable financial system, while also exacerbating the vulnerabilities of certain segments of the population, including small and medium-sized enterprises, non-profit organizations, and marginalized communities (Economides et al., 2019). By thoroughly examining the impact of de-risking on European financial systems, this research aimed at contributing to the ongoing dialogue on the development of effective policy measures and regulatory frameworks that can counteract the negative effects of de-risking and promote financial inclusion and stability (Cecchetti & Schoenholtz, 2020).

1.2 Research Objective

The aim of this research was to explore the Ripple Effect and Consequences of Correspondent Banking De-Risking on Global Financial Inclusion and Stability.

2.1 Theoretical Framework

Risk management theory informed the study. Risk management theory is a systematic approach to identifying, assessing, and mitigating risks in order to minimize potential negative consequences and optimize opportunities. This field of study has developed over the years, drawing from various disciplines such as finance, engineering, and psychology (Knight, 1921; Markowitz, 1952). By understanding and applying risk management principles, organizations can make better decisions, enhance their reputation, and improve overall performance (COSO, 2004).

One of the foundational concepts in risk management is the distinction between risk and uncertainty. Knight (1921) defined risk as a situation where the probability distribution of outcomes is known, while uncertainty refers to situations where the probability distribution is unknown. This distinction is important because it helps organizations to better categorize potential threats and develop appropriate strategies to manage them (Knight, 1921). Another significant aspect of risk management theory is the idea of diversification. This principle, introduced by Markowitz (1952) in his Modern Portfolio Theory, posits that combining assets with different risk-return profiles can reduce overall portfolio risk without sacrificing expected returns. This concept has since been applied to a wide range of fields, including project management, supply chain management, and cybersecurity (Markowitz, 1952).

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed the Enterprise Risk Management (ERM) framework in 2004. This comprehensive framework seeks to integrate risk management into an organization's strategic planning and decision-making processes. It emphasizes the importance of establishing a risk appetite, identifying and assessing risks, and implementing appropriate risk responses (COSO, 2004). In recent years, risk management theory has expanded to include behavioral and psychological factors that can influence decision-making under uncertainty. Researchers like Kahneman and Tversky (1979) have explored cognitive biases and heuristics that can lead to suboptimal decisions, emphasizing the importance of incorporating behavioral insights into risk management practices. By understanding these biases and developing strategies to mitigate their effects, organizations can further enhance their risk management capabilities (Kahneman & Tversky, 1979).

The theory is internal to the organization and it looks at de-risking as a factor of compliance to Anti-money laundering, terrorist financing and customer due diligence standards. Likewise, the study used political theory in relation to power and hierarchy or pecking order between the correspondent and the respondent banks, hence a combination of theories that touch on both the macro and microenvironment which in unison are important elements in understanding de-risking. Political theory finds meaning in analysis of philosophies and principles that are crucial to political thought; it interrogates the impact of political actions that attempts to respond to various enquiries that touch on freedom, power, authority and legitimacy, among others (Heywood, 2004).

On risk management theory, which in broader terms is the process by which organizations identify, measure, rank and alleviate the negative effects of the known and the unknown. (Mohammeda & Knapkovaa, 2016). Specific to this study, the theory of risk management uses Enterprise Risk Management (ERM) theory; a holistic approach to risk management, where all risks are viewed together within a harmonized strategic framework, risk is recognized not to be only about threats but also opportunities (Spikin, 2013). It is on this premise, that respondent banks are required to comply with risk management regulations with a bias to Anti-Money Laundering (AML) and Customer due diligence (CDD) or know your customer (KYC) standards across all the three levels of the organization, the `front office as first line, the second as risk officers and the third as auditors. (McLean, et al., January 2018).

Risk management theory is a central concept in understanding bank de-risking, as it involves the identification, assessment, and mitigation of potential risks to a financial institution's operations and reputation (Power, 2017). In the context of correspondent banking de-risking, the primary driver is the need to manage risks associated with anti-money laundering (AML) and combating the financing of terrorism (CFT) regulations. Financial institutions are increasingly required to adopt stringent compliance measures, which often lead to the termination of correspondent banking relationships (CBRs) in order to minimize exposure to potential penalties or reputational damage (Economides et al., 2019). Thus, risk management theory highlights the importance of striking a balance between managing regulatory risks and maintaining the accessibility and stability of financial services (Cecchetti & Schoenholtz, 2020).

The phenomenon of de-risking in correspondent banking has garnered significant attention in recent years, as financial institutions withdraw or restrict their services in response to stringent regulatory requirements, high compliance costs, and reputational risks (Starnes, Bottega, & Hohl, 2017). This process can have a ripple effect on global financial inclusion and stability, as it may disproportionately influence vulnerable populations and developing economies by limiting access to critical financial services (Erbenová *et al.*, 2016). Risk management theory provides a valuable lens for understanding and addressing the consequences of de-risking in correspondent banking.

De-risking can be viewed as a manifestation of risk aversion and the application of the precautionary principle, which posits that in situations of uncertainty, financial institutions should err on the side of caution to minimize potential negative consequences (Coates & Sandler, 2017). However, the implementation of stringent risk management measures may inadvertently create negative externalities, such as reduced access to financial services for certain customers or regions, and contribute to financial exclusion (Erbenová *et al.*, 2016). This highlights the need for a more holistic approach to risk management that considers both the direct and indirect consequences of de-risking decisions.

The concept of diversification, which is central to risk management theory (Markowitz, 1952), can also be applied to the de-risking phenomenon. Diversification suggests that by engaging with a broader range of counterparties and regions, financial institutions can mitigate the concentration of risk associated with overexposure to specific sectors or geographies. However, de-risking can lead to the opposite effect by concentrating risk in certain areas, potentially exacerbating financial instability and further marginalizing vulnerable populations (Starnes *et al.,* 2017).

To address the ripple effects and consequences of correspondent banking de-risking on global financial inclusion and stability, policymakers and regulators should consider a more balanced approach to risk management that incorporates the broader implications of de-risking decisions. This may involve fostering dialogue between regulators and the financial sector, promoting transparency and information sharing, and encouraging innovation in compliance and risk management practices (Erbenová *et al.*, 2016; Starnes *et al.,* 2017). By adopting a more comprehensive risk management perspective, the financial sector can better balance the need for compliance and security with the overarching goal of fostering financial inclusion and stability.

2.2 Literature Review

A study conducted by Economides et al. (2019) investigated the challenges faced by the European banking industry due to de-risking. The study found that the termination of correspondent banking relationships (CBRs) had led to reduced access to cross-border financial services, disproportionately affecting small and medium-sized enterprises, non-profit organizations, and marginalized communities. The authors emphasized the need for a harmonized regulatory framework across European countries and a risk-based approach to address these challenges.

In a similar vein, Cecchetti and Schoenholtz (2020) analyzed the continuing threat of correspondent banking de-risking in Europe. The authors found that de-risking had disrupted the flow of remittances, trade finance, and development aid, resulting in negative repercussions on financial inclusion and stability. Furthermore, they observed an increased reliance on less-regulated, informal channels, which in turn undermined the global AML/CFT regime and exacerbated financial crime and systemic risks. The study called for enhanced collaboration and coordination among regulatory authorities, financial institutions, and affected stakeholders to develop targeted strategies and regulatory frameworks that balance the need for stringent compliance measures with the importance of maintaining access to essential financial services.

Gordon et-al, (2018), have also penned their thoughts on de-risking in the Caribbean, thou the scope of the research was only in the EU, they go ahead to say that its effects on the EU ripples to other parts of the world, confirming that it's a global phenomenon. They opined that this phenomenon is a result of deeper scrutiny due to the global financial crisis of 2007/08 and it's aimed at enforcing and combating terrorist financing and money laundering (Gordon, et al., 2018). The researchers have concentrated their efforts on regulatory gaps in the EU, that if not addressed will catalyze customers categorized as high risk due to money laundering to fend for options that do not have the requisite tools and capabilities to monitor customer transactions, hence a strategy that literally defeats itself (Gordon, et al., 2018). Gordon et-al, (2018), conclude de-risking as a concept that exposes the European society to money laundering; as there are no sanctions levelled upon post de-risking to high risk clients. Pointing to a weakness within the system may be it is reporting or a gap between the regulator and other sectors of the government (Gordon, et al., 2018).

McCauley (2018) explored the role of correspondent banking in global finance and its implications for European financial systems. The study emphasized that the consequences of de-risking threatened to undermine financial integration, restrict access to essential financial services, and exacerbate economic disparities among different regions and demographic groups in Europe. The author stressed the importance of developing effective policy measures and regulatory frameworks to counteract the negative effects of de-risking and promote financial inclusion and stability in the region.

In a study by the Financial Stability Board (FSB), it was found that de-risking in correspondent banking had led to a decline in the number of active correspondent relationships, particularly affecting smaller banks, and had implications for the provision of financial services in some jurisdictions (FSB, 2019). This reduction in correspondent relationships can create concentration risk, as banks become more reliant on a smaller number of counterparties, thereby increasing the potential for systemic risk and decreasing financial stability (FSB, 2019).

The European Banking Authority (EBA) has also explored the effects of de-risking on financial inclusion in Europe. In their opinion paper, the EBA emphasized the need for a balanced approach to de-risking that considers both the risks and benefits associated with providing services to higher-risk customers (EBA, 2019). By implementing overly stringent de-risking measures, financial institutions may inadvertently exclude legitimate customers from accessing necessary financial services, contributing to financial exclusion and potential social and economic instability (EBA, 2019).

A study by the European Parliament's Policy Department for Economic, Scientific, and Quality of Life Policies examined the relationship between de-risking and financial inclusion in Europe, with a focus on the impact on remittance flows (García-Herrero & Ribakova, 2019). The study found that de-risking can lead to reduced access to remittance services and higher costs for migrants, who often rely on these services to send money back to their home countries. This, in turn, has implications for financial inclusion and overall economic development (García-Herrero & Ribakova, 2019).

The impact of de-risking on non-profit organizations (NPOs) has also been examined, as these organizations are often disproportionately affected by de-risking measures due to concerns about money laundering and terrorist financing (Goredema, 2019). The closure of NPOs' bank accounts can hinder their ability to carry out crucial humanitarian and development work, which can have significant consequences for the communities they serve, as well as broader implications for financial inclusion and stability (Goredema, 2019).

As a response to the negative consequences of de-risking, various stakeholders have advocated for the development of innovative solutions to address these challenges. For example, the International Monetary Fund (IMF) has highlighted the potential of fintech to help counter the effects of de-risking by providing alternative channels for remittance flows and promoting financial inclusion (IMF, 2020). By leveraging digital technologies, financial institutions may be able to better manage risk while still providing essential services to higher-risk customers (IMF, 2020).

In conclusion, although empirical research specifically addressing the ripple effect and consequences of correspondent banking de-risking on global financial inclusion and stability in Europe between 2019 and 2020 is limited; several recent studies provide valuable insights into the broader implications of de-risking. The decline in correspondent relationships and the resulting concentration risk, the impact on remittance flows, and the challenges faced by NPOs all point to the need for a more balanced approach to de-risking that considers both the risks and the benefits of providing services to higher-risk customers.

In a broader context, Erbenova *et al*. (2017) conducted a comprehensive analysis of the causes and consequences of the withdrawal of correspondent banking relationships on a global scale. The study found that de-risking had led to significant challenges for affected countries and institutions, particularly in terms of financial inclusion, economic growth, and stability. The authors recommended a coordinated, multi-faceted approach to address the negative repercussions of de-risking, involving collaboration among international organizations, national authorities, and financial institutions to improve communication, risk assessment, and capacity building.

Correspondent banking in the Caribbean is important in supporting humanitarian and inter-boundary payments. Despite this, correspondents from the USA, Canada and Europe are moving from this market, with 21 of the 23 banks in 2017 losing a relation, this decision is driven by fear of fines, reputational risk and losses due to fraud through money laundering and terrorist financing (MacDonald, October 2019). A paradox noted by the researcher is that, in spite of constantly changing compliance regulations by USA and European banks, through the financial stability board (FATF) and Organization for Economic Cooperation and Development (OECD), and expecting Caribbean banks to comply, they, themselves do not comply to the standards; he goes ahead to note that, it is easy to establish a Limited liability company in the USA and the law does not compel the shareholders to disclose the ultimate beneficiary, evidence of selective application of compliance regulations, making USA and UK a tax evasion and money laundering destination. (MacDonald, October 2019). Finally, one bank in the region that has survived the onslaught by the correspondence banks is the Republic Financial Holdings (RFL) Limited; the paper attributes this to its robust anti money laundering and Customer due diligence processes. (MacDonald, October 2019)

According to a World bank (2018) report, the de-risking decision by large banks is principally a business decision that the business is high risk low return, to make correspondent banking attractive, financial technology and automation of compliance with the aim of making it effective would be the plausible way out. The notion that country risk was a chief contributor to de-risking has been disproved by this report. The report however agrees that the respondent banks will have to look for substitute routes for remittance. More communication between the respondent and correspondent, improving of regulatory environment and a risk management approach to AML and KYC, which does not address the cost versus benefit thought stand taken by the correspondence, are some of the recommendations suggested.

3.0 Methodology

This study employed a descriptive research design to explore the ripple effect and consequences of correspondent banking de-risking on global financial inclusion and stability. The study was quantitative in nature as it employed quantitative data. The research was on quantifiable figures and is operational in offering answers to direct questions. This descriptive research design approach removed control over the variables from the researcher and only allow him to report on what is happening or what has happened. Linear regression model was fitted to show the relationship between the two variable.

4.0 Findings and Discussion

The model summary results show that the coefficient of determination (R squared) is 0.393 and adjusted R squared of 0.346 at 95% significance level. The R squared of 0.393 implies that de-risking explains 39.3% of the variation in financial inclusion and stability in Europe. This indicates that de-risking has a moderate impact on financial inclusion and stability in the region, and it is an important factor to consider when analyzing the European financial landscape. However, it is essential to keep in mind that the R-squared value alone does not provide a complete picture of the relationship between de-risking and financial inclusion and stability.

It is important to recognize that other factors contribute to the remaining 60.7% of variation in financial inclusion and stability in Europe. These factors may include economic conditions, political stability, regulatory frameworks, technological advancements, demographic shifts, and other financial sector policies. Furthermore, the R-squared value does not indicate the direction or strength of the relationship between de-risking and financial inclusion and stability. A more in-depth analysis, including examining the regression coefficients, would be necessary to determine the specific impact of de-risking on financial inclusion and stability in Europe.

Additionally, it is essential to consider the limitations and assumptions inherent in any statistical analysis. For example, the R-squared value assumes that the relationship between de-risking and financial inclusion and stability is linear, which may not always be the case. Other relationships or interactions between variables could be present but not captured by the R-squared value.

The adjusted R square of 0.346 depicts that de-risking in exclusion of the constant variable explains the variation in financial inclusion and stability in Europe by 34.6 percent .The remaining 60.7% of the variation in Financial Inclusion and Stability can be explained by other factors/variables, which were not part of the current study.

Table 1: ANOVA

Model		Sum of Squares	Df	Mean Square	F	Sig.
	Regression	1.885	1	1.885	8.422	.012[b]
	Residual	2.91	13	0.224		
1	Total	4.796	14			

a. Dependent Variable: Financial Inclusion and Stability
b. Predictors: (Constant), De-risking

The analysis of variance results in Table 1 reveal that the model was statistically significant in explaining the impact of de-risking on the Financial Inclusion and Stability and it is indicated by a p-value of 0.012<0.05.

Table 2: Regression Coefficients

Model		Unstandardized Coefficients		Standardized Coefficients	T	Sig.
		B	Std. Error	Beta		
1	(Constant)	5.907	0.671		8.801	0.000
	De-risking	-0.470	0.162	-0.627	-2.902	0.012

a. Dependent Variable: Financial Inclusion and Stability

The regression coefficient results shows that there existed a negative and statistically significant relationship between de-risking and Financial Inclusion and Stability (β=-0.470, p=.012<.05). This implies that a unit increase in de-risking leads to a decline in f Financial Inclusion and Stability by 0.470 units. This implies that de-risking has negative impact of Financial Inclusion and Stability in Europe. This points to the fact that Anti-Money-Laundering, and Combating-the-Financing-of-Terrorism compliance costs have resulted in the exit of several banks from cross-border relationships with many emerging market clients and markets, particularly in the correspondent banking business. The findings implies that de-risking has the potential to affect many cross-border banking activities, particularly those underpinned by correspondent banking relationships.

The findings imply that de-risking can lead to financial exclusion, as financial institutions may terminate relationships with customers or sectors that are perceived as high-risk, such as money service businesses, non-profit organizations, and politically exposed persons. This exclusion may disproportionately affect vulnerable populations, such as migrants and low-income individuals, who rely on these services for remittances, welfare payments, and other essential transactions (García-Herrero & Ribakova, 2019). When legitimate customers lose access to the formal financial system, they may be forced to turn to informal or unregulated channels, further exacerbating financial exclusion and hindering efforts to promote financial inclusion. Moreover, it is evident that de-risking can contribute to the concentration of risk within the financial system. As financial institutions limit their correspondent banking relationships, they become more reliant on a smaller number of counterparties, increasing the potential for systemic risk (FSB, 2019).

This concentration of risk can make the financial system more vulnerable to shocks and reduce overall financial stability, as problems in one institution can more easily spread to others in the interconnected network. In addition, de-risking can hinder economic development and growth, particularly in regions that are dependent on remittances and foreign direct investment. By reducing access to financial services and increasing the cost of transactions, de-risking can create barriers to trade, inhibit investment, and ultimately slow down economic progress. This can have long-term consequences for financial stability and social cohesion, as financial exclusion can exacerbate income inequality and social unrest. De-risking has significant negative consequences for financial inclusion and stability. It can lead to financial exclusion for vulnerable populations, contribute to the concentration of risk within the financial system, and hinder economic development. Policymakers, regulators, and financial institutions need to strike a balance between compliance with AML/CTF regulations and ensuring access to financial services for legitimate customers in order to promote financial inclusion and maintain stability in the global financial system.

Discussions

Based on the findings presented above, De-risking has emerged as a significant concern in recent years, influencing global financial inclusion and stability, particularly in Europe. De-risking refers to the practice of financial institutions reducing or terminating business relationships with clients or categories of clients deemed to be high risk in terms of money laundering or terrorist financing. This practice has been primarily driven by increased regulatory scrutiny and the high costs associated with compliance to Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) regulations.

De-risking in correspondent banking, where banks provide services to other banks, has led to a decline in the number of active correspondent relationships. This reduction particularly affects smaller banks and jurisdictions with limited access to financial services. The decline in correspondent relationships contributes to the concentration risk in the financial system, as banks become more reliant on a smaller number of counterparties. This heightened concentration risk increases the potential for systemic risk and decreases overall financial stability in Europe.

Financial inclusion is also negatively impacted by de-risking, as certain groups, such as migrants, non-profit organizations, and individuals from higher-risk jurisdictions, are disproportionately affected. The withdrawal of services from these vulnerable populations can lead to financial exclusion, which in turn reduces access to remittance services and hinders economic development. Financial exclusion can exacerbate income inequality and social unrest, further contributing to economic instability in the affected regions.

In response to the challenges posed by de-risking, various stakeholders have advocated for a more balanced approach that considers both the risks and benefits associated with providing services to higher-risk customers. Policymakers, regulators, and financial institutions should adopt risk-based decision-making processes that minimize financial exclusion without compromising AML/CFT compliance. This can be achieved through refining risk assessment methodologies and providing clearer regulatory guidance.

Moreover, fostering international cooperation and coordination can help address the challenges posed by de-risking in correspondent banking. Collaboration between governments, regulators, and financial institutions at the international level is necessary for sharing best practices, developing common risk assessment frameworks, and promoting regulatory clarity. A coordinated approach can help financial institutions better navigate the complex landscape of correspondent banking and ensure that the global financial system remains inclusive and stable.

Finally, innovative fintech solutions can help counter the effects of de-risking by providing alternative channels for remittance flows and promoting financial inclusion. By leveraging digital technologies, financial institutions may be able to better manage risk while still providing essential services to higher-risk customers. Encouraging the adoption of fintech solutions and creating enabling environments for fintech innovation can play a crucial role in mitigating the negative consequences of de-risking on financial inclusion and stability in Europe.

5.0 Conclusions

Banks in Europe are maintaining broad networks of correspondent banking relationships, but there are growing indications that this situation might be changing. The banks in Europe are reducing the number of relationships they maintain and are establishing few new ones. The impact of this trend is uneven across jurisdictions and banks within Europe. As a result, some respondent banks are likely to maintain relationships, whereas others might risk being cut off from international payment networks. The study also concludes that respondent banks, regulator, policy makers and other stakeholders bridge the gap between the respondent and correspondent banks in Europe through enhanced regulatory guidance, which includes ensuring that the correspondent institution generally does not have direct business relationships with the customers of the respondent institution, unless it provides payable-through-account services. Additionally, correspondent institutions in assessing the risks of their respondent must ensure that the assessment is sufficiently robust to consider all the relevant risk factors. By doing so, the different levels of inherent risks

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are clearly understood and appropriate controls applied to each, ensuring the effective management of these risks.

The study furthermore concludes that, when entering into a business relationship, as a first step, the correspondent bank is required to identify and verify the identity of the respondent institution, using reliable, independent source documents, data or information. It should also identify and take reasonable measures to verify the identity of the beneficial owner(s), such that the correspondent institution is satisfied that it knows who the beneficial owner(s) of the respondent institution is/are. The study also concludes that de-risking have negative and significant impact the Financial Inclusion and Stability in Europe.

The Correspondent banking relationships connect banks and people across borders and are critical to finance and trade; they are a vital link between emerging markets and the broader global economy. Yet efforts to combat money laundering and the financing of terrorism have increased compliance requirements for banks. The study concludes that difficulties adhering to these requirements and increased costs associated with them threaten the ability of banks to serve their customers, while also eroding the number and quality of correspondent banking relationships.

Based on the findings, it is concluded that De-risking can limit the contribution that banks and financial systems can make in strengthening a country's stability and macroeconomic growth, as financial sector development matters for economic development and poverty reduction. The study finally concludes that because of de-risking, banks in Europe are faced with challenges that reduces their ability to serve customers across borders. The most frequently cited driver for a reduction in banks' ability to serve their customers was compliance requirements, followed by correspondent banking stress, and market competition and prices.

The ripple effect and consequences of correspondent banking de-risking have significant implications for global financial inclusion and stability, particularly in the European context. The decline in active correspondent relationships, driven by stringent regulatory requirements and high compliance costs, has led to concentration risk within the financial system, increased reliance on fewer counterparties, and the potential for systemic risk. This can further undermine financial stability and create vulnerabilities within the interconnected global financial network.

De-risking measures also have negative consequences for financial inclusion, as they disproportionately affect vulnerable populations, including migrants, non-profit organizations, and individuals from higher-risk jurisdictions. The withdrawal of services from these groups can result in financial exclusion, reduced access to remittance services, and hindered economic development. This exclusion can exacerbate income inequality and social unrest, further contributing to economic instability in the affected regions.

To address the challenges posed by de-risking, policymakers, regulators, and financial institutions must adopt a more balanced approach that considers both the risks and benefits of providing services to higher-risk customers. This can be achieved through international collaboration, sharing of best practices, the development of common risk assessment frameworks, and the promotion of regulatory clarity. In addition, leveraging innovative fintech solutions can help counter the effects of de-risking by providing alternative channels for remittance flows and promoting financial inclusion.

Ultimately, understanding and addressing the ripple effects and consequences of correspondent banking de-risking are crucial for ensuring financial inclusion and stability in Europe and beyond.

By adopting a more comprehensive and balanced approach to risk management, the financial sector can better balance the need for compliance and security with the overarching goal of fostering financial inclusion and maintaining stability in the global financial system.

6.0 Recommendation

First, it is crucial to enhance the collaboration and coordination among regulatory authorities, financial institutions, and affected stakeholders in order to address the consequences of correspondent banking de-risking. A harmonized regulatory framework across European countries should be developed to reduce the complexity and cost of compliance for financial institutions while maintaining the effectiveness of AML/CFT measures. Furthermore, policymakers should consider implementing a risk-based approach that allows for more nuanced assessments of clients and regions, reducing the likelihood of over-de-risking. Establishing a centralized information-sharing platform among relevant stakeholders could facilitate the exchange of best practices, improve risk management processes, and promote transparency in the financial sector.

Additionally, targeted capacity-building efforts should be undertaken to support financial institutions in jurisdictions heavily affected by de-risking. Technical assistance and training programs could be provided to enhance these institutions' ability to comply with international standards, address deficiencies in their AML/CFT regimes, and improve their overall risk management capabilities. In addition, European policymakers should explore innovative financial solutions and technologies, such as distributed ledger technology or digital currencies, to reduce reliance on correspondent banking and foster more resilient, accessible financial systems.

It is also essential to develop financial inclusion strategies that prioritize the needs of the most vulnerable segments of the population, including small and medium-sized enterprises, non-profit organizations, and marginalized communities. Policymakers should encourage the expansion of alternative financial services, such as mobile banking and peer-to-peer lending platforms, to improve access to essential financial services and promote financial inclusion. Furthermore, efforts should be made to raise awareness and educate affected stakeholders about the consequences of correspondent banking de-risking and the available alternatives, fostering a more informed and inclusive financial landscape.

Promote a balanced approach to de-risking: Policymakers, regulators, and financial institutions should adopt a more balanced approach to de-risking that weighs the potential risks and benefits of providing services to higher-risk customers. This can involve refining risk assessment methodologies, providing clearer regulatory guidance, and encouraging financial institutions to engage in risk-based decision-making processes that minimize financial exclusion without compromising AML/CTF compliance.

Foster international cooperation and coordination: To address the challenges posed by de-risking in correspondent banking, greater cooperation and coordination among governments, regulators, and financial institutions at the international level are necessary. This collaboration could include sharing best practices, developing common risk assessment frameworks, and promoting regulatory clarity. A coordinated approach can help financial institutions better navigate the complex landscape of correspondent banking and ensure that the global financial system remains inclusive and stable.

Leverage fintech and digital solutions: Encourage the adoption of innovative fintech solutions that can help counter the effects of de-risking by providing alternative channels for remittance flows and promoting financial inclusion. By leveraging digital technologies, financial institutions may be able to better manage risk while still providing essential services to higher-risk customers. Regulators should also create enabling environments for fintech innovation while ensuring that new technologies are deployed responsibly and securely.

Enhance capacity building and technical assistance: Governments and international organizations should provide targeted capacity building and technical assistance to help countries and financial institutions address the challenges associated with de-risking. This support could include training on risk assessment and management, assistance with AML/CTF compliance, and the development of legal and regulatory frameworks that balance the need for security with the goal of fostering financial inclusion. By enhancing the capacity of countries and institutions to manage risk effectively, the negative consequences of de-risking can be mitigated, and financial inclusion and stability can be maintained. By implementing these recommendations, the financial sector can strike a balance between compliance with AML/CTF regulations and ensuring access to financial services for legitimate customers, promoting financial inclusion and stability in Europe and beyond.

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