De-risking and illicit financial flows

The role of regional economic hubs

August 2020

Authors

Barry Cooper
Masiiwa Rusare
Matthew Ferreira
Fabrice Gatwabuyege

Cenfri

Tel. +27 21 913 9510
Email: info@cenfri.org
The Vineyards Office Estate
Farm 1, Block A
99 Jip de Jager Drive
Bellville, 7530
South Africa

PO Box 5966
Tygervalley, 7535
South Africa

www.cenfri.org

Table of contents

List of tables

List of figures

List of abbreviations

ACAMS	Association of Certified Anti-Money Laundering Specialists
AFI	Alliance for Financial Inclusion
AML-CFT	anti-money laundering and combatting the financing of terrorism
AUSTRAC	Australian Transaction Reports and Analysis Centre
CBK	Central Bank of Kenya
CBR	corresponding banking relationships
CDD	customer due diligence
CMA	Common Monetary Area
COMESA	Common Market for Eastern and Southern Africa
CPI	consumer price inflation
DOTS	Direction of Trade Statistics
DRC	Democratic Republic of the Congo
EAC	East African Community
ECOWAS	Economic Community of West African States
ESAAMG	Eastern and Southern Africa Anti-Money Laundering Group
FAFT	Financial Action Task Force
FDI	foreign direct investment
FSB	Financial Stability Board
FSP	financial service provider
GDP	gross domestic product
GFI	Global Financial Integrity
IAMTN	International Association of Money Transfer Networks
IFC	international financial centre
IFFs	illicit financial flows
IMF	International Monetary Fund
KYC	know your customer
MENAFAFT	Middle East & North Africa Financial Action Task Force (MENAFATF)
ML	money laundering

MTO	money transfer operators
NGOs	non-governmental organisations
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OFC	offshore financial centre
PEP	politically exposed person
RFC	regional financial centre
SADC	Southern African Development Community
SARB	South African Reserve Bank
SMEs	small and medium-sized enterprises
SSA	sub-Saharan Africa
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TBML	trade-based money laundering
TF	terror financing
TJN	Tax Justice Network
UNCTAD	United Nations Conference on Trade and Development
UNECA	United Nations Economic Commission for Africa
UNHCR	United Nations High Commissioner for Refugees
USD	United States Dollar
WTO	World Trade Organisation

1. Introduction

Capital flows: important for economic development. Capital flows or moves between capital-rich and capital-poor countries depending on the opportunities for return on investment. These capital flows can consist of official capital flows, which include official development assistance and aid in the form of grants or loans, as well as private capital flows such as bank and trade-related lending, foreign direct investment, portfolio investments and workers' remittances (Mhlanga & Christy, 2006). Foreign direct investment (FDI), foreign aid and remittances are the major capital inflows in Africa. Such inflows play an important role in regional economic development. Between 2000 and 2017, FDI contributed an average of 3.4% to regional GDP in sub-Saharan Africa (SSA), with foreign aid and remittances contributing an average of 3.3% and 2.3% respectively (World Bank, 2018). These capital flows support job creation, skills and technology transfer, provide financing for government budgets and contribute to long-term economic growth (UNCTAD, 2006).

Regional economic hubs helping to facilitate movement of capital. Regional economic hubs can be defined as countries that play a significant role in the economy of the broader region. They tend to have the most developed financial markets in the region as well as more favourable or developed regulatory environments. Hence, they act as gateways for capital to flow into countries they are integrated with (their spoke countries). This interconnection between regional economic hubs and spokes can help create stable financial flows for countries in a region and contribute to the development of their financial systems (Fanelli, 2008).

Decisions to de-risk undermining capital flows. Capital flows are affected by the risk or perceived risk of illicit financial flows (IFFs). Regional economic hubs can act as channels for IFFs, thereby in effect regionalising IFFs. The risk of IFFs leads to the practice of de-risking, whereby financial institutions limit or sever business relationships to avoid exposure to certain types of risks. De-risking could, however, adversely affect capital flows and financial inclusion. Recent years have seen large scale de-risking and financial exclusion happening in developing countries, particularly those countries that most need capital flows to finance social services, aid and development. Where regional economic hubs are de-risked, it has a profound effect on the developmental outcomes for the hub itself as well as the spoke countries it is integrated with. It reduces opportunities to be included in the financial sector, cuts off countries from legitimate capital flows and reduces the stability of the financial sector.

Financial integrity important to secure capital flows. To stem the risk of IFFs, the threat of being de-risked and the corresponding knock-on effect on capital flows, it is important to ensure that there are adequate regulatory frameworks in place to promote a robust level of financial integrity in a way that does not undermine inclusion. Once again, hubs play an important role in spreading best practices within the region.

Better understanding the interplay. This note forms part of a two-note series. This is Note 1, and its purpose is to highlight the relationship between de-risking, IFFs and capital flows in the context of regional economic hubs. To do so, we will firstly explore what a regional economic hub is and its role in economic development. Then we will investigate the concepts of de-risking and IFFs and the interlinkages between the two, to understand how they affect capital flows. Finally, we discuss the way forward and provide recommendations on dealing with the challenge of de-risking and IFFs. Note 2 deep-dives into the concept of a regional economic hub, exploring the methodologies for determining which countries are hubs within their respective regions. While Note 1 relies on the methodologies explored and utilised in Note 2, readers should refer to Note 2 for more details and specifics on the concept of economic hubs.

The structure of the paper is as follows:

- **Section 2** explores and defines the concept of a regional economic hub and identifies relevant regional hubs in SSA.
- **Section 3** investigates the relationship between de-risking and IFFs and the impact thereof on capital flows in the context of regional hubs.
- **Section 4** concludes on the key messages from the report and provides a set of recommendations.

2. Regional economic hubs and their role in capital flows and economic development

To understand the interplay between IFFs and de-risking in regional context, we first explore what a regional economic hub is and what forms it can take. On this basis, we then identify relevant hubs in SSA.

2.1. Defining regional economic hubs

"Economic hub" as a broad concept. In its broadest sense, an economic hub is a city or country that serves as network aggregation point for a region. According to network theory, network aggregation points represent a confluence of different factors, such as trade lines, trade proximity, information and communication infrastructure, financial networks, social networks and logistics infrastructure (Graham, 2015; Bernard & Moxnes, 2017). The combination of these factors makes the hub the "economic heart" of the region. For the purpose of this note, we are interested in economic hubs that are large enough to have regional influence in terms of development, policymaking and compliance. We define a regional economic hub as "a regional centre that plays a significant role in the economy of the broader region". In the rest of this note, a "hub" country means the major economy influencing regional peers, while a "spoke" country is a regional country being influenced by the hub.

Well-established in economic literature. There exists sound economic literature to explain how economic hubs are formed. Paul Krugman's theory on geography and trade describes how individual producers tend to locate themselves where demand is large or where supply of inputs is particularly convenient (Krugman, 1991). The gravity model of international trade explains how hub countries are important for regional trade as smaller economies will depend on these large economies for trade activity (Tinbergen, 1962). Finally, regional economic integration theory can be used to explain how linkages between an economic hub and its surrounding regions are formed, which in turn plays a role in the level of influence a hub can hold in terms of policy-setting and compliance[1]. More information about these theories can be found in Note 2.

1 Regional influence is important as it allows a country the ability to shape and put in place economic and political policies in a geographic region which in turn has implications for the nations situated in the area

Different types. Different types of hubs can exist within the broad definition of a regional economic hub, namely:

- **Financial hubs** can be understood as a city, region or country where financial service providers (FSPs) are clustered and where a large volume of financial transactions are coordinated and cleared (Cassis and Bussiere, 2005). According to the International Monetary Fund (IMF), these hubs can be classified into three types (IMF,2000):
  - Firstly, international financial hubs/centres (IFCs), which are large, international, full-service centres with advanced settlement and payments systems, such as New York or London
  - Secondly, regional financial hubs/centres (RFCs), which intermediate funds in and out of their region such as Hong Kong and Singapore
  - Thirdly, offshore finance hubs/centres (OFCs), which tend to be lightly regulated and provide tax advantages, such as the Cayman Islands
- **Trade hubs** are defined by the role the hub country plays in facilitating trade in the region. For instance, an export-destination hub refers to a country that is the major export destination for most of the other countries in the region. On the other hand, an import-source hub refers to a country that many other countries rely on as their major source of imports (Huang et al, 2018). A trade hub can also be viewed as an area where some trade logistics take place, such as the beneficiation of goods or where goods are swapped and re-exported, rather than a terminal that simply facilitates the re-exportation of one good – e.g. a country that just re-exports oil and coal without doing beneficiation.
- **Industry hubs** arise because of a combination of different factors, which include location, access to human capital, natural resource endowments, infrastructure and logistics networks as well as the regulation and policy in place. The mix of these different factors can lead to the development of specialist hubs, such as automotive hubs and technology hubs. For example, Silicon Valley in San Francisco is well known as an international "tech hub", while Stuttgart in Germany is well known as an automotive manufacturing hub.

Some hybrid hubs, some specialist. Some hubs exhibit a mixture of the different characteristics of the above-mentioned financial, trade and industry hubs. These can be referred to as "mixed hubs". For example, Johannesburg is an economic hub in South Africa as well as being a financial hub more specifically. Shanghai can be viewed as a mixed hub due to the level of regional financial and trade activity that takes place there[2]. On the other hand, some hubs are specialist hubs, for example where they have highly advanced financial sectors that facilitate regional financial flows, yet their economies are relatively small compared to others in the region, e.g. Mauritius.

2 Shanghai was the world's busiest container port in 2018, handling 42.01 million twenty-foot equivalent units, up from 4.4% in 2017. For more information see: https://theloadstar.com/shanghai-still-worlds-busiest-container-port-but-singapore-is-climbing-back. In addition, Shanghai ranked as one of the top five financial centres in the world according to the March 2019 edition of the Global Financial Centres Index. For more information see: https://www.shine.cn/biz/finance/1903141199/e

2.2. Role in capital flows

It is clear from the typology above that economic hubs can play various roles in economic development in a region, such as facilitating regional trade or industrial development. The role that we are most interested in for the purpose of this note is the way in which regional hubs shape capital flows. This role plays off directly, as well as indirectly via the effect on regulation and compliance best practices:

Facilitating inflows by expanding financial depth. The role of regional hubs to channel capital from developed markets into developing economies is well established in literature (Obstfeld, 2007; Adam et al., 2015). Hubs help to facilitate capital flows by "mobilising foreign direct investment, facilitating private equity funds and intermediating funds from development finance institutions" (Hatayama, 2019). A hub like Mauritius, for example, serves as a gateway for financial flows into SSA because of its favourable business and regulatory environment, which helps to attract capital flows from developed economies. Hubs therefore provide financial depth[3], allowing local companies to benefit from improved access to financial resources and to increase their leverage by having access to a range of financial instruments that would otherwise have not been available to them (Esen and Gokmenoglu, 2016).

Influencing policymaking, regulation and compliance practices. The role that hubs play as mediators of trade and capital flows affords them economic and political strength, which can be used to shape the action of spoke countries. This influence can help shape policy and regulation within a region, for instance through supervisory colleges where regulators in a hub country and those in its spoke countries jointly regulate and supervise financial institutions that have a regional presence[4]. The role can also be implicit, such as where spokes look to the example set by the hub in developing their regulatory frameworks, or where institutions in the region set their compliance practices based on that of the regional parent company. In this way, regulatory and compliance best practices from a hub spill over into a spoke country.

Spread of AML-CFT compliance practices. One area of compliance practice that is particularly relevant to this note is anti-money laundering and combating the financing of terrorism (AML-CFT) practices, as it shapes the de-risking activities of financial institutions, which in turn affect capital flows. When financial institutions from hub countries expand to other countries in the region, these multinational financial institutions either adopt their own group compliance standards in relation to AML-CFT or the host country's standards, whichever is the highest and does not contravene local regulations (Stakeholder interviews, 2019). This means that a hub country's AML-CFT practices spread into spoke countries by way of the branches or subsidiaries of regional financial institutions. Such spill-over of AML-CFT best practice also happens when a regional player sets an example which other institutions emulate, or through public−private sector forums in which various actors discuss AML-CFT requirements with local regulators.

3 Financial depth captures the financial sector relative to the economy. It is the size of banks, other financial institutions, and financial markets in a country, taken together and compared to a measure of economic output.

4 In stakeholder interviews the example of Kenya was used. If a Kenyan bank licensed by the Central Bank of Kenya (CBK) wants to operate in Tanzania, it must meet the requirements of the Bank of Tanzania, which gives them the license in Tanzania. However, the Tanzanian license must be concurrent with the primary regulator, the CBK. This can be challenging if the regulatory requirements in one country are very different from another. To ensure that the bank operates in line with both regulators, supervisors regularly utilize supervisory colleges which enable supervisors to jointly regulate an FSP that has presence in more than one jurisdiction.

2.3 Identifying hubs in Africa

Combination of different economic indicators used to identify a hub. Having positioned the concept of regional economic hubs and the roles that hubs can fulfil, we now identify relevant hubs in Africa that can serve as case studies for how the effect of de-risking and IFFs on capital flows plays off on the continent. The first step in identifying specific hubs on the continent was to identify indicators that, together, would determine whether a country is classified as a hub. These are outlined in Table 1 on the next page:

Indicator	Description
Regional GDP country share	Country's percentage share of regional GDP
Ease of doing business Index	Measures of business regulations and their enforcement in a country. A high score indicates that the regulatory environment is conducive to business operation.
Level of regional economic integration	Agreements, transactions and trade flows between groups of countries in a geographic region, to reduce and ultimately remove tariff and non-tariff barriers to the free flow of goods, services and factors of production between each other.
Percentage share of intra-regional trade	Country's percentage share of regional trade taking into account its imports and exports
Logistics performance index	Reflects perceptions of a country's logistics based on efficiency of customs clearance process, quality of trade- and transport-related infrastructure, ease of arranging competitively priced shipments, quality of logistics services, ability to track and trace consignments, and frequency with which shipments reach the consignee within the scheduled time.
Trade as a percentage of GDP	The ratio of exports and imports to GDP. It is an indicator of the relative importance of international trade in the economy of a country.
Share of regional inward FDI stock	Country's percentage share of the stock of regional inward foreign direct investment
Source of FDI for regional peers	Percentage share of outward foreign direct investment that flows to other countries
Stock of immigrants from within Africa	Stock of African migrants found in the country

Table 1: List of possible hub indicators

Sources: UNCTAD, World Bank

Using these economic indicators, we conducted a data analysis on nine potential hub countries[5] in in the Southern African Development Community (SADC), the East Africa Community (EAC), the Economic Community of West African States (ECOWAS), North Africa and Maghreb regions. The data was summarised into a checklist on how each country scores relative to the hub criteria. More detail on the results of the analysis and checklist can be

5 Côte d'Ivoire, Egypt, Ghana, Kenya, Mauritius, Morocco, Nigeria, Seychelles and South Africa

found in Note 2 of this note series. Note 2 focuses solely on the topic of regional economic hubs in Africa. On this basis, we identified the following hubs:

- ***South Africa: SSA-wide hub.*** South Africa stands out as the sample country that meets most of the hub indicators. This is as a result of the significant share of regional GDP and intra-regional trade that South Africa commands, its good-quality trade logistics, ability to attract a large share of FDI stock, its deep level of integration and its draw as a destination for immigrants from within Africa. The nation plays an important role in the rest of SSA and is therefore a well-established financial and trade hub in the region.
- ***Kenya, Nigeria and Morocco: hubs in their respective regions.*** Kenya, Nigeria and Morocco each meets a number of criteria that suggest they serve as hubs in their respective regions. Kenya is a regional economic powerhouse in the EAC region. It represents a significant share of intra-regional trade, is deeply integrated into the region, attracts a large share of FDI and is an important destination for migrants. In ECOWAS, Nigeria stands out due to the size of its economy, large share of intra-regional trade, ability to attract FDI and its appeal as a destination for migrants. In North Africa, Morocco's ease of doing business and importance to regional trade sets it up as hub among regional peers.
- ***Mauritius and Seychelles: conduits of FDI.*** Whilst not seen as economic powerhouses relative to other hubs such as South Africa and Nigeria, Mauritius and the Seychelles act as hubs for the facilitation of financial flows into the rest of Africa. This is largely down to the ease of doing business in these countries, their high level of integration into the region due to their memberships in regional groups such as SADC and the Common Market for Eastern and Southern Africa (COMESA) and the way in which their regulatory regimes, including tax regulations, support business operations.
- With an understanding in place of the concept of regional economic hubs, the role they play and which countries in Africa can be considered hubs in their respective regions, we now turn our attention to investigating the concepts of de-risking and IFFs and how they play out in regional economic hubs. This will be done by defining each concept in turn, assessing the scale of each in hubs in Africa and investigating the interlinkages between the two and how they affect capital flows into the continent as well as between hubs and spokes.

3. Relationship between de-risking, IFFs and capital flows in the context of hubs

De-risking and IFFs both have far-reaching implications for capital flows. Where banks make de-risking decisions, it affects capital flows by limiting the channels through which these flows can be accessed, while the presence of IFFs means that there is less legitimate capital flowing in and out of countries. These two phenomena are interlinked and reinforce each other, meaning that de-risking can lead to a rise in IFFs; and a rise in IFFs can lead to de-risking. As a result, legitimate capital flows between regional economic hubs and their spokes can be compromised. Lower capital flows, in turn, affect the development trajectory of a country's financial sector, with repercussions for levels of financial inclusion and overall economic development. This chapter explores the interlinked relationship between these two concepts:

- Section 3.1 takes a closer look at **de-risking and its relation to IFFs and capital flows** by outlining what de-risking is, what drives it, the scale of de-risking in regional hubs in Africa and how it relates to IFFs and capital flows in the context of regional hubs.
- Section 3.2 does the same for **IFFs and their relation to de-risking and capital flows.**

3.1. De-risking and its relation to IFFs and capital flows

What is de-risking?

The termination or limiting of business relationships to avoid risk. De-risking can be defined as "the phenomenon of financial institutions terminating or restricting business relationships with clients or categories of clients to avoid, rather than manage, risk in line with the FATF's risk-based approach" (FAFT, 2014). The FATF is the Financial Action Task Force, the global standard-setting body on Anti-Money Laundering and Combatting the Financing of Terrorism (AML-CFT). Thus, de-risking is a phenomenon that takes place in the context of AML-CFT. De-risking can come in three main forms, namely:

- **Local financial institution to individual customer:** This involves the closure of (or refusal to open) bank accounts for certain individuals and firms and other restrictions on access to financial services.
- **Local financial institutions to local financial institution/business:** This type of de-risking entails banks withdrawing or restricting their services to non-bank financial institutions such as money transfer operators (MTOs), payments providers and other remittances facilities, as well as from non-financial institutions such as small and medium-sized enterprises (SMEs).

- **Correspondent bank to local bank:** This type of de-risking entails the severing of correspondent banking relationships[6] (CBRs), which can entail the loss of access to the international payments clearing system for the bank that has been de-risked as well as for its customers.

These forms of de-risking are interrelated and respond to one another. For example, the de-risking of local institutions by foreign institutions may lead to further de-risking of local institutions by other local institutions.

What drives de-risking?

High ML-TF risk reported as the key reason for de-risking. Financial institutions operating in the East African region have indicated that money laundering (ML) and terror financing (TF) risks have been the primary reasons behind their decision to de-risk and end their CBRs. According to a survey conducted by the East African Anti-Money Laundering Group (ESAAMLG), financial institutions mentioned unacceptable levels of ML-TF risk inherent in certain customers, jurisdictions and products, services, transactions or delivery channels as reasons for severing or limiting business relationships in the region (ESAAMLG, 2017). As discussed above, high levels of ML-TF risk as a reason for de-risking are not necessarily evidence of risk avoidance if the *perceived* level of ML risk is aligned with the *actua*l level of ML-TF risk. However, in practice, financial institutions face a number of additional interrelated challenges that influence decision-making:

- **Limited information.** Where information on the scale and nature of ML-TF risks posed by different client groups is limited, it is difficult for financial institutions to make well-informed risk assessments with regard to their clients or jurisdictions in which they operate. This can lead to banks relying on broad indicators such as jurisdiction and product type and their size to generate risk profiles. This approach can result in a number of different clients of varied risk levels being lumped into the same risk bracket and potentially being de-risked even though they do not present substantial ML and/or TF risks (stakeholder interviews, 2019).
- **Cost of compliance.** The cost incurred by a financial institution to comply with international AML-CFT standards creates incentives for a financial institution to terminate business relations with categories of clients that it does not deem cost-effective to serve (Durner and Shetret, 2015).
- **Penalties.** Where non-compliance with the AML-CFT regulatory environment means that a financial institution would incur penalties and suffer reputational damage, it creates the incentive to terminate business relations rather than maintaining them and applying the appropriate consumer due diligence controls (stakeholder interview, 2019).

Figure 1 uses a simple demand-and-supply curve to broadly illustrate the potential implications of addressing de-risking drivers, and how this would affect supply and demand. Limited information, cost of compliance as well as the risk of fines and penalties are all supply-side constraints which, if addressed, would shift the supply curve to the right. Limited information is also a demand-side constraint: For the consumer, requiring documents is either an administrative burden or an outright barrier. Addressing the documents burden would

6 A correspondent banking relationship occurs when an agreement between or arrangement between foreign institutions is made in order to facilitate the provision of cross-border payments and services. For example, a Tanzania bank wanting to provide payments services to the U.S would require a correspondent banking relationship to facilitate such payments.

therefore shift demand to the right. This results in more accounts supplied at a lower price point, represented by the shift from **e1** to **e2**.

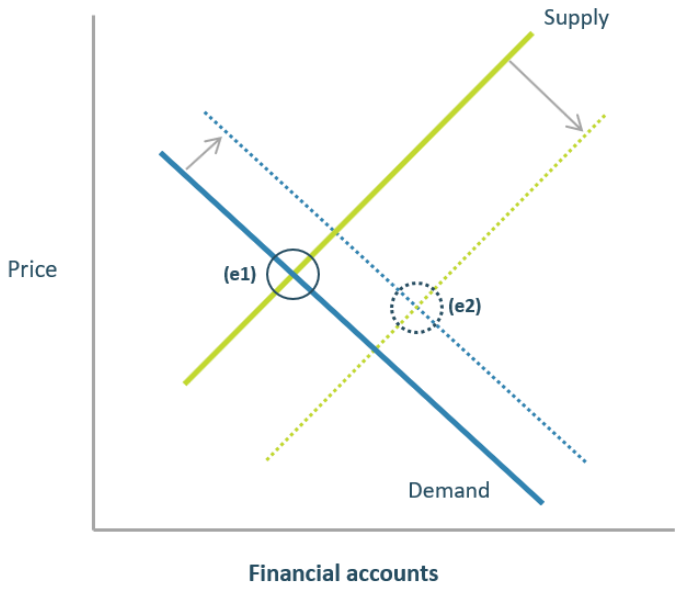

Figure 1: Drivers of de-risking
Source: Authors' own

As shown in Figure 1, each of these factors on its own is unlikely to lead to substantial de-risking, but together the effect is amplified. Ultimately, as a result of little information on ML-TF risk, high cost of compliance and the potential for penalties, institutions are de-risking in a bid to avoid *compliance risk* (the risk of incurring penalties as a result of non-compliance) that comes with banking those particular clients – even where the official reason for de-risking may be understood or interpreted as "unacceptable ML-TF risk". As such, addressing the problem of de-risking requires a more holistic look at the challenges that financial institutions are facing beyond the idea that certain jurisdictions/clients simply have high-risk profiles**.**

Lack of alignment and coordination between country AML-CFT frameworks limiting the ability to reduce de-risking. Efforts to reduce de-risking through, for example, changing customer due diligence (CDD) requirements does not always have the desired impact on the behaviour of financial institutions. Institutions often still choose to adopt stricter approaches to due diligence because these approaches are ostensibly less risky and less likely to result in fines. Moreover, multinational banks that have a presence in African countries (including hubs) are largely concerned with the compliance requirements of their primary regulator from their head office jurisdiction and will not alter their compliance frameworks if it does not align with the regulations and compliance standards in that jurisdiction (stakeholder interviews, 2019)[7]. As such, changing the regulation in one jurisdiction has no effect on multinational banks if there is not alignment and understanding between the local regulators and international regulators. This means that local regulators may not be in a position to reduce de-risking even through legal implementations.

7 For For example, if a regulator in Kenya chooses to adjust CDD requirements to encourage different approaches to CDD which may reduce financial exclusion, banks with a multinational presence will not necessarily endorse or apply that approach because they need to comply with regulation in their home jurisdiction, which may view such behaviour as risky in a different context.

What is the scale of de-risking?

World-wide phenomenon. Data from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) shows that the decision to de-risk because of the above-mentioned factors has resulted in a widespread loss of banking relationships across the globe. SWIFT data revealed that the number of active CBRs declined globally by 6% between 2011 and the end of 2016. The regions that were found to be especially affected by de-risking include the Caribbean, the small states of the Pacific, the Middle East and North Africa, Central Asia and sub-Saharan Africa.

Regional hubs across Africa losing banking relationships. There has been significant de-risking in the hub countries in Africa identified in Section 2.3. This could have profound implications for the region. Figure 2 shows the extent of de-risking (in terms of CBRs) in the hub countries compared to the average in Africa. As can be seen, the Seychelles, Morocco and Mauritius were the most affected. The high occurrence of de-risking in Morocco could be explained by the fact that the country is exposed to terrorism financing risks (MENAFATF, 2019). Given that the Seychelles and Mauritius are prominent financial hubs, de-risking in these countries has significant implications for the flow of finance into the broader region. Levels of de-risking in Kenya, Côte d'Ivoire and Nigeria is lower than the Africa average. According to stakeholder interviews (2019), local-to-local-level de-risking in Nigeria has been more frequent than the international-to-local de-risking reflected on the graph. While levels of de-risking come in below the regional average in Kenya, the effects thereof are still significant. A survey conducted by ESAAMLG revealed that 13 respondent banks had experienced a termination or restriction of CBRs between 2011 and 2016 (ESAAMLG, 2017).

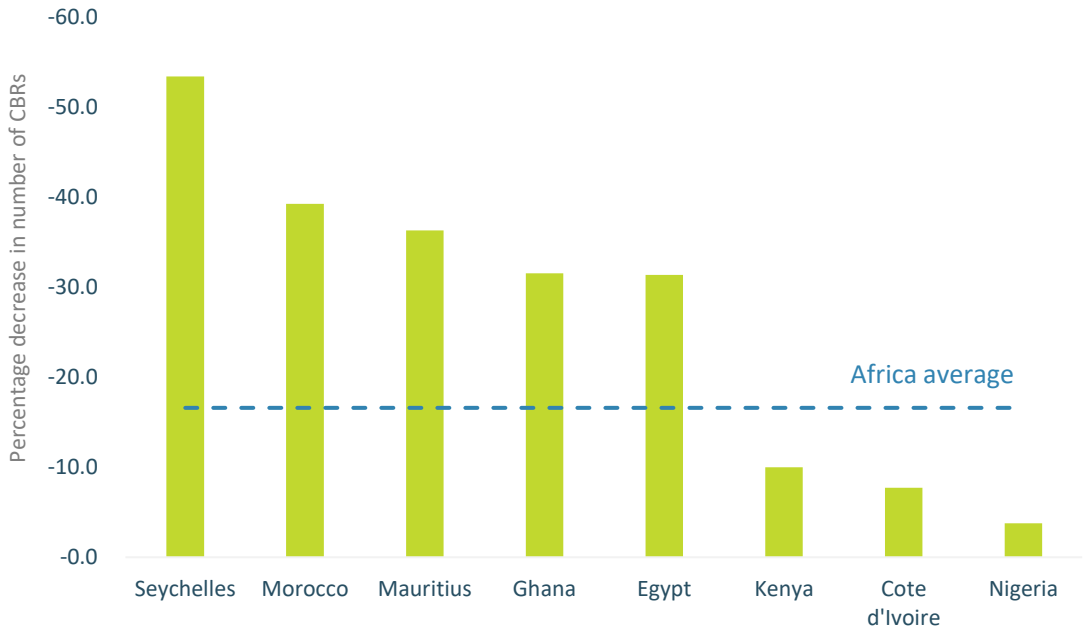

Figure 2: De-risking in hub countries compared with Africa average (2012−2018)

Source: Bank for international settlements

What are the implications of de-risking for IFFs and capital flows in regional hubs?

Avoidance of risk having negative consequences for the broader market. As stated in the definition of de-risking quoted above, de-risking involves the *avoidance* of risk rather than the *management* of risk. This entails institutions choosing to avoid doing business with clients altogether, rather than understanding and managing the risks associated with those clients. The problem with risk avoidance as a primary strategy instead of risk management is that it results in the termination of many lower-risk accounts that do not present a material money laundering (ML) or terrorist financing (TF) risk, and it results in widespread unintended implications for the market. In particular, it creates financial exclusion risk – the risk of large-scale financial exclusion, which results in the development of alternative channels – and reduces legitimate channels through which capital can flow. Moreover, given the role that hubs play in facilitating flows to the rest of their respective regions, distortion of such channels between hubs and international markets can have extended consequences for other countries in the region.

The rest of this discussion outlines the negative implications of de-risking of (i) individual consumers, (ii) businesses like small and medium-sized enterprises (SMEs), non-governmental organisations (NGOs) and remittances providers and (iii) smaller financial institutions.

Impact of de-risking on individuals

Risk versus profit. The de-risking of individuals occurs when financial institutions, notably banks, decide to terminate the accounts of individuals or groups of individuals. It may also refer to the refusal to open accounts for certain types of individuals. Lower-income populations are often on the resulting end of large-scale de-risking (Langthaner & Nino, 2017). These populations typically demand low-value accounts and do not represent significant profit opportunities for FSPs. In some cases, they may even represent a loss when the cost of compliance is accounted for. As such, banks choose to simply remove this customer segment from their business. Other high-risk customers may also be de-risked, such as politically exposed persons (PEPs). Some banks explicitly do not deal with PEPs while others may deal with them depending on the results of a risk assessment (Stakeholder Interviews, 2019).

Results in financial exclusion. Wholesale de-risking results in certain customer segments being excluded from formal financial services[8]. In a survey conducted by ESAAMLG on its member countries, nine jurisdictions noted that de-risking was a threat to financial inclusion, and six jurisdictions pointed out that de-risking negatively affected access to financial products (ESAAMLG, 2017).

8 Informal financial services are different from the informal sector more broadly. The informal sector includes all business that are not regulated, but these institutions may still make use of formal financial services. On the other hand, informal financial services refer specifically to business providing financial services that are not regulated. These may be used by formal or informal businesses.

Weaker financial sector, reduced capital flows. Financial inclusion contributes significantly to financial sector development and stability (Centre for Global Finance, 2018)[9]. The strength and stability of a country's financial sector, in turn, is a key driver of capital flows. Therefore, the implications of financial exclusion are decreased financial sector strength and decreased capital flows. Where this happens in a regional hub, it can affect the whole region by decreasing the ability to meet financial needs in the region.

Growth of shadow financial services and IFFs. The exclusion of groups of individuals does not reduce their demand for financial services. Rather, it implies that such individuals will make use of less strictly regulated and monitored financial services. Increasing use of informal financial services (e.g. informal remittance networks) increases the scale of these services, making them more profitable and more viable. For example, the World Bank reported a total value of USD1.27 billion of formal remittances in the Democratic Republic of the Congo (DRC) in 2014, while informal remittances in 2014 were estimated to be between USD7 billion and USD9 billion (Thom et al., 2017). Given that these channels are unregulated and unmonitored, they create an enabling environment for IFFs and financial crime.

Shifting risk between institutions does not remove IFF risk. De-risking of individuals does not always result in them turning to informal financial services, as they may be able to use other formal financial services. Particularly in the case of PEPs and other clients who are de-risked due to excessive levels of ML and reputational risk rather than low profitability, the act of de-risking serves to shift ML risk from one institution to the next, rather than to actually mitigate that ML risk. As mentioned in previous sections, the focus of institutions on compliance risk (and particularly reputational risks) leads them to cut off high-profile clients rather than to monitor them. However, high-risk clients are then absorbed by smaller banks with less developed customer due diligence (CDD) processes that do not track IFFs as effectively (Stakeholder Interviews, 2019). As a result, ML risk at a systemic level is increased by de-risking[10].

Impact of de-risking on businesses and institutions

Focus on SMEs, NGOs and remittance providers. De-risking can affect a range of businesses. Here we focus specifically on the impact on SMEs, NGOs and remittance providers, as banks usually perceive them to be high risk[11] and, hence, they can be disproportionally affected by de-risking compared to larger corporates.

9 Financial inclusion influences financial sector positively in a number of ways. Firstly, it enables banks and FSPs to engage new business areas and diversify their portfolios by reaching the previously unbanked. Secondly, it enables individuals to survive socio-economic shocks and provides access to credit. Thirdly, the widening scale of the formal financial systems enhances the impact of monetary policy by ensuring that monetary policy signals are effectively transmitted to the real sector. Finally, the inclusion of more people in the formal system reduces information asymmetries allowing for better application of the risk-based approach and more targeted financial products that address people's needs.

10 Stakeholder interviews in Nigeria suggest that emerging Fintechs, especially those operating in blockchain and other new technologies, can be abused for IFFs as they often have less robust compliance measures and are less well understood and regulated by supervisors. This is particularly problematic where they are providing services to high profile customers like PEPs, who have been de-risked form large institutions.

11 This is due to limited access to information in the case of SMEs, or the fact that they do business in what is seen as high-risk jurisdictions in the case of NGOs and remittance providers.

SMEs hit hard by institutional de-risking. SMEs account for as much as 90% of all businesses, 50% of employment and 40% of GDP across Africa, yet they face significant funding constraints (Cohen, 2019). These businesses have a high probability of being de-risked due to the following reasons (Artingstall et al., 2016):

- Banks have revenue requirements that SMEs are less likely to be able to meet.
- The size of the firm is sometimes used as proxy for compliance effectiveness, and hence SMEs are perceived to have weak compliance and AML-CFT frameworks.
- Banks and large firms have similar compliance controls and functions in terms of structure and organisation, whereas SME controls are often very different and more complicated to understand.

Rejected trade financing limits capital access for SMEs. De-risked SMEs are unable to access trade financing. According to the World Trade Organisation (WTO), SMEs are the most affected when it comes to access to trade financing, with 60% of all trade finance requests by SMEs globally being rejected, against only 7% for multinational companies (WTO, 2019). Trade financing is an important vehicle for channelling capital flows into developing countries. Exclusion from trade financing impedes SMEs' business operations and development opportunities.

De-risking of businesses fuelling IFFs through growth of shadow banking. Businesses that are unable to access the formal financial system may turn to accessing services through the shadow banking sector[12]. For example, in South Africa, the shadow banking system accounted for about 25% of total assets in the financial system in 2014, compared to 31% for the traditional banking sector and 40% for the insurance and pension sector (SARB, 2014). While the shadow banking sector provides an alternative source of finance to support business activities, a large shadow banking sector risks becoming a vehicle for undetected, unmonitored IFFs (Fjeldstad, 2017). A large shadow banking sector can also affect the effectiveness of monetary policy by increasing money supply and the value of consumer price inflation (CPI), resulting in a central bank not being able to fulfil its goal of price stability (Hasien & Yazdifar, 2015).

De-risking of NGOs reduces aid flow, increases cash usage and can lead to IFFs. NGOs face a high probability of de-risking, particularly when they work in high-risk jurisdictions, which is often where aid is most needed. Where they face delays or refusals in opening bank accounts, or where accounts are closed due to de-risking, it can slow their response time to deliver aid to deal with crises[13]. According to a 2018 survey by the Association of Certified Anti-Money Laundering Specialists (ACAMS), 15% of all US NGOs that work abroad have faced account closures or refusals (ACAMS, 2018). As a result, some NGOs have resorted to transporting cash[14] or turning to money transfer operators with less strict controls (Centre for Global Development, 2018). This leaves them exposed to higher risks and reduced transparency, creating a vacuum in which IFFs can proliferate. The de-risking of NGOs also has a direct negative impact on financial inclusion where NGOs act as intermediaries between banks and the unbanked or work directly on financial-inclusion-related matters.

12 Shadow banking refers to non-bank institutions that provide services outside of the traditional regulated banking system.

13 Such as the Covid-19 pandemic which was front of mind at the time of writing.

14 Cash usage (particularly cash transportation) is unmonitored and common in transnational crime (OECD, 2009).

De-risking of remittance providers affecting livelihoods and driving IFFs. Similar to NGOs, remittance providers face a high risk of de-risking due to the fact that they are often located in jurisdictions that have elevated IFF risks, have underdeveloped AML-CFT frameworks and serve low-end customers who normally have little or no documentation (stakeholder interviews, 2019). For example, data from the Australian Transaction Reports and Analysis Centre (AUSTRAC) indicates that Australian banks between 2014 and mid-2015 closed 720 accounts of remittance service providers and affiliates. The closure of remittance accounts in the Pacific islands directly resulted in individuals resorting to alternative mechanisms for transferring money which were legal in some cases and in others were not (Stakeholder Interviews, 2019). Times of global crisis, such as the COVID-19 pandemic, can lead to increases in de-risking of remittance providers. A survey conducted by the International Association of Money Transfer Networks (IAMTN), a global international trade organisation that represents the money transfer industry, showed that 69% of respondents[15] indicated they had experienced a sudden decrease in remittance volumes as a result of the coronavirus pandemic (IAMTN, 2020). This could make maintaining banking relationships with these entities less attractive as the volume of transactions decreases relative to the costs of banking their customer base, which leads to de-risking.

Secondary de-risking where the institution's bank is de-risked. To gain access to cross-border payment services needed (such as international payments or trade financing), SMEs, NGOs and remittances providers alike rely on CBRs between their local banks and international correspondent banks. The restricting or termination of business relationships between respondent banks in any particular country and correspondent banks thus results in SMEs, NGOs and remittance providers in that country being de facto de-risked as well. This may prompt them to use less regulated channels, which creates the environment for IFFs to occur. This effect may be amplified in the case where banks in regional financial hubs are de-risked, as all the financial service providers in that region relying on them for international banking services will also be cut off. This can potentially result in the growth of illicit flow channels between hub and spoke countries that distort the integrity of the financial system in the region.

Impact of de-risking on financial institutions

De-risking affecting small banks and potentially leading to IFF risks. According to stakeholder interviews (2019) in hub countries, small or new banks are the financial institutions most likely to have their correspondent services cut off. This means that they cannot access cross-border services directly but need to do so via larger banks with correspondent banking relationships. This can have significant cost implications for these small institutions[16]. To remain competitive, they either have to save costs elsewhere or provide niche services. Another option is to bank profitable customers that are high risk and may have been de-risked by bigger banks, such as PEPs. If these PEPs have significant power or influence over the board of directors in small banks, they may be able to influence compliance practices, ultimately lowering compliance standards and utilising these banks to facilitate IFFs (stakeholder interviews, 2019). This ultimately weakens the integrity of the financial sector, and where this happens in hub countries it can spread into the various spokes that connect to it.

15 Respondents represent banks, non-bank financial institutions, cross-border payment hubs, remittance network providers, and current exchanges of differing size, capacity, and offerings.

16 Stakeholder interviews revealed that U.S banks are unwilling to have direct relationships with small or new banks in Nigeria, so they must go through big local banks.

The discussion above showed how de-risking results in individuals, businesses and financial institutions being cut off from transparent, regulated and legitimate financial services. This lack of access to formal financial services may prompt individuals and institutions to utilise less regulated channels in order to meet their financial needs, which creates the scope for IFFs. The next sub-section will delve deeper into the concept of IFFs and how it, in turn, can lead to de-risking.

3.2. IFFs and their relation to de-risking and capital flows

Section 3.1 considered the phenomenon of de-risking: how it arises due to the need to minimise the risk of AML-CFT and IFFs but also how it can inadvertently facilitate IFFs. This section will explore IFFs in more depth by providing a definition of the concept, investigating the scale thereof in hubs in Africa, as well as by outlining how IFFs relate to de-risking and affect capital flows.

What are IFFs?

Unregulated financial flows across borders. While there is no clear consensus on the definition of IFFs, they are typically understood as unregulated financial flows that move across borders (i.e. illicit financial inflows and outflows). For example, Cobham (2015) refers to IFFs as flows that are "forbidden by law, rules or customs". Global Financial Integrity (GFI) defines IFFs as the illegal movement of funds from one country to another. This includes money that is "illegally earned, used or transferred" (GFI, 2020). For this note, we adopt a similar definition, namely "capital, financial and resource flows that are earned, transferred, intermediated and/or used illegally." (Cooper et al, 2018).

Broader than just AML-CFT or trade-based money laundering. Figure **3** shows that IFFs are a broad concept that includes financial crimes such as money laundering and the financing of terrorism, as well as trade-based money laundering (TBML)[17] involving trade and transfer mispricing. However, due to the lack of consensus on the definition of IFFs, many countries do not explicitly incorporate all these elements into their risk assessments (stakeholder engagements, 2018): Some countries view IFFs as a trade issue only, whereas global standards under the FATF define IFFs narrowly from an ML point of view. This means that there are inconsistencies and gaps in frameworks that deal with IFFs.

17 TBML refers to a process whereby perpetrators use invoice faking and similar methods, often facilitated by the freight forwarding industry, to launder money through the trade system.

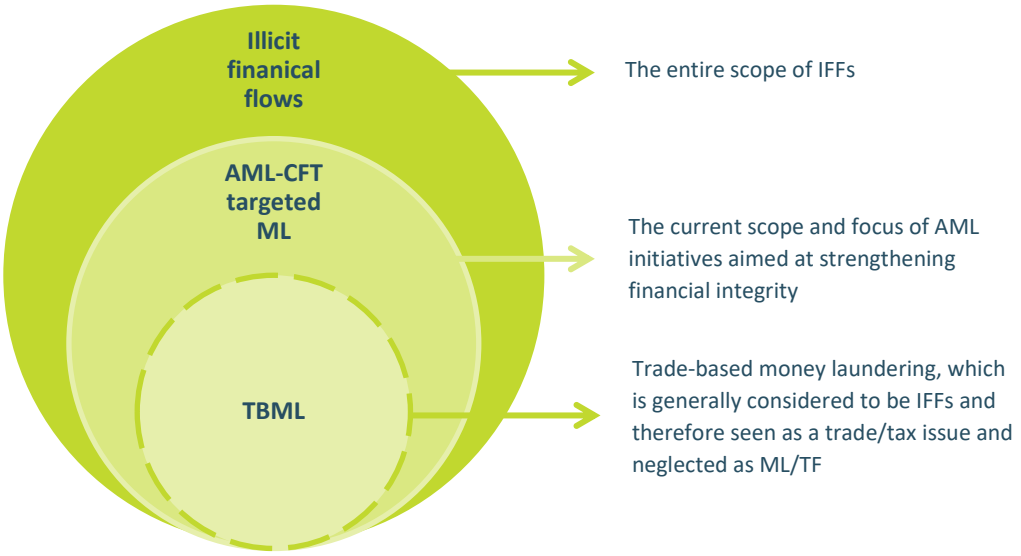

Figure 3: The scope and components of IFFs
Source: Cooper et al. (2018)

What drives IFFs?

From our literature review and stakeholder consultations, we've identified three factors that can lead to the proliferation of IFFs in regional hubs and their spokes in Africa, namely:

- ***Underdeveloped or inappropriate legislative environments.*** The ease with which capital or resources are transferred illicitly often depends on the quality and strength of a country's legislative environment. A weak legislative environment in which the concepts of ML and TF are not explicitly defined as illegal acts makes it easier to conceal illicit capital flows and harder to prosecute offenders of criminal activities. Conversely, where AML-CFT regulators and supervisors overregulate, individuals and businesses may be unnecessarily excluded from the formal financial system, thereby creating incentives for IFFs to grow (Vorobyeva, 2018). Drafting effective, risk-based AML-CFT regulation is difficult, even in the developed-country context. Moreover, mutual evaluations[18] are sometimes inconsistent and do not readily reward progressive regulation that, for example, may reduce financial exclusion and IFF risk (Cenfri engagements, 2018 & 2019). As discussed in Section 2.3, spoke countries often learn from hubs as they develop legislation. Thus, hubs play an important role in setting the standard for legal efforts to combat IFFs. Moreover, weaknesses in legal frameworks in hubs can facilitate illicit flows into the broader region.
- ***Natural resources, weak governance and corruption.*** The presence of an abundance of natural resources, coupled with a weak regulatory framework for the country's resource revenues, can act as a catalyst for rent-seeking, corruption and, ultimately, illicit flows. The FATF notes that countries whose exports depend on minerals and natural resources are prone to governance issues and corruption (FAFT, 2012). Cenfri's work across Africa finds that weak governance frameworks are the result of state institutions being underfunded and understaffed. In addition, some countries lack the technology to effectively track, identify and combat IFFs. It is important to take cognisance of how

18 "FATF mutual evaluations are in-depth country reports analysing the implementation and effectiveness of measures to combat money laundering and terrorist financing. Mutual evaluations are peer reviews, where members from different countries assess another country".

difficult IFFs are to combat, particularly in states that have small tax bases and where the rule of law is still developing.

- ***Existence of secrecy jurisdictions and tax havens.*** The destination for IFFs is just as important in facilitating IFFs as the origin thereof. According to the high-level panel for IFFs headed by Thabo Mbeki at UNECA, financial secrecy jurisdictions and tax havens are part of the pull factors or enablers of IFFs (UNECA, 2018). Tax havens incentivise the movement of profits away from high tax zones to low tax zones, while secrecy jurisdictions enable the movement and ownership of funds to remain anonymous. The Tax Justice Network's (TJN)'s 2020 Financial Secrecy Index[19] reveals that there are five African countries in the top 50 global secrecy jurisdictions, namely Algeria (23), Kenya (24), Nigeria (34), Angola (35) and Egypt (46). The GFI estimates that about 45% of illicit flows end up in offshore financial centres (GFI, 2017), showing that hubs, particularly those with strong financial sectors that facilitate significant investment flows, can be abused for illicit financial flow purposes.

What is the scale of IFFs?

The presence of one or more of the above-mentioned factors in countries across Africa, including in hub countries, has led to a rise in the presence of IFFs on the continent. Below, we highlight the scale of this phenomenon.

Increasing trend. According to data from Global Financial Integrity, trade-related IFFs[20] in SSA grew from 16.5% of total trade with advanced economies (AEs) in 2006 to 20.2% of total trade with AEs in 2015, as illustrated in Figure 4[21] (GFI, 2019). Figure 4 also highlights how trade-related IFFs are relatively volatile in SSA, dropping from 22.2% of total trade with AEs in 2008 to 15.2% of total trade with AEs in 2010, after which they rise again steadily to 20.2% of total trade. The volatility may be due to inconsistent reporting by countries. Alternatively, it may be due to deviances in the degree to which criminals manage to successfully hide IFFs from reporting mechanisms such as International Monetary Fund (IMF) Direction of Trade Statistics (DOTS). Overall, the increasing trend of IFFs is a concern for SSA.

19 The Financial Secrecy Index ranks each country based on how intensely the country's legal and financial system allows wealthy individuals and criminals to hide and launder money extracted from around the world. The index grades each country's legal and financial system with a secrecy score out of 100 where a zero out of 100 is full transparency and a 100 out of 100 is full secrecy.

20 Estimates of the illicit flows of money into and out of countries because of their trade in goods. While trade-related IFFs are not the only type of IFFs, this is the only type for which data on scale is available.

21 Estimates based on data from United Nations Comtrade database.

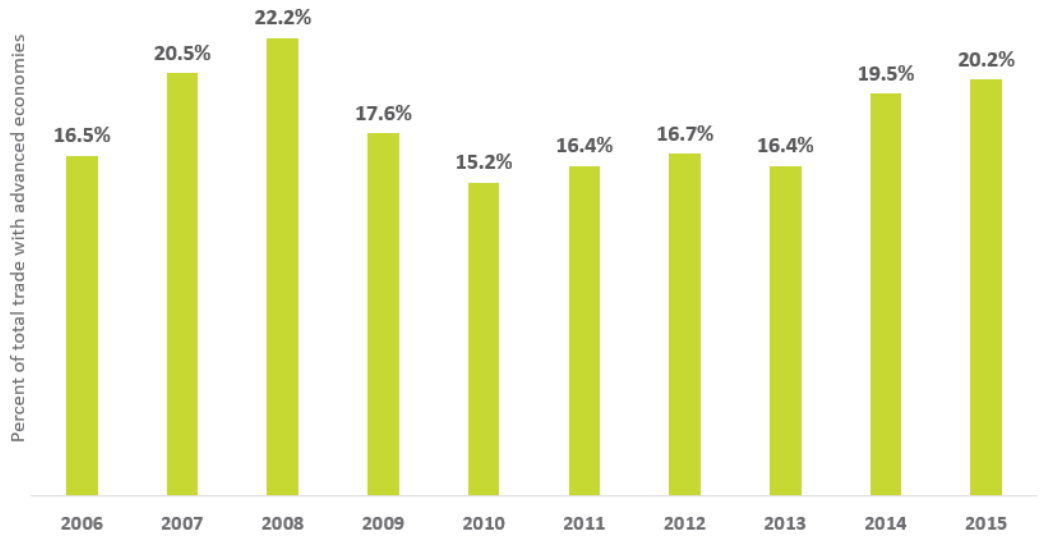

Figure 4: Trade-related IFFs in SSA
Source: GFI (2019)

High risk of IFFs in hub countries. Trade-related IFFs are relatively high in the regional economic hub countries in Africa that were identified in Section 2.3. Table 2 illustrates that Mauritius is the lowest-risk country with trade-related IFFs representing 15% of total country trade with advanced economies, while Senegal and South Africa are the highest at 21% of total country trade with advanced economies each. In Nigeria and Kenya, there was no data available. A lack of data can imply an inability to properly contextualise the challenge of IFFs and hence address it holistically. This can worsen the risk of IFFs in a country.

Country	Trade-related IFFs as a percentage of total country trade with advanced economies in 2015
Kenya	No data
Senegal	21%
Nigeria	No data
South Africa	21%
Mauritius	16%
Côte d'Ivoire	18%
Egypt	19%
Morocco	19%

Table 2: Risk of trade-related IFFs in regional hubs in Africa
Source: GFI (2019)

What are the implications of IFFs for de-risking and capital flows?

Having defined what IFFs are, the drivers behind their proliferation and the scale of the challenge in hubs across Africa, we now turn to the implications of IFFs for de-risking and capital flows.

Reduced tax base and impaired investment climate. Illicit outflows represent a drain of capital from an economy. The types of economic activity associated with IFFs are typically of a rent-seeking nature or outright illegal and are often hard to regulate or track. The inability to track and clamp down on IFFs means that governments lose out on tax revenues from these flows. As a result, governments' ability to spend on important initiatives like social services, social grants and infrastructure maintenance is impeded. This may create a situation in which governments need to borrow to fund the gap in their budget, thereby increasing public sector debt. Illicit outflows can therefore potentially keep countries in a cycle of borrowing, debt repayment and capital flight (Global Justice Now, 2017). This, in turn, may decrease investor confidence, both local and international, lead to credit ratings downgrades, hurt legitimate capital inflows and result in de-risking.

Less effective monetary policy. Not only do IFFs negatively affect a government's fiscal position, they also impede its monetary policy and hurt a country's financial sector. According to FATF (2019), unchecked money laundering can have the following consequences:

- Unmonitored changes in money in circulation, which undermines monetary policy
- Raised prudential risks in the banking sector
- Contamination effects on legal financial transactions
- Increased volatility of international capital flows and exchange rates due to unanticipated cross-border asset transfers

Ineffective monetary policy, in turn, negatively affects macroeconomic fundamentals such as inflation and GDP. Such fundamentals are typically used as indicators for de-risking decisions and directly affect the attractiveness of a country as a destination for capital flows.

Deterioration of state capacity. Not only do IFFs affect a government's fiscal and monetary policies, they lead to an overall deterioration of state capacity. This is because IFFs entrench corruption and create a culture of rent-seeking activity. The capacity and ability of a state and its institutions to undertake key responsibilities are a driver of its attractiveness as a destination for capital flows and a risk parameter that banks use to make decisions on de-risking. As a result, states and state institutions that are viewed as poorly run and corrupt detract capital investment and signal risk, which increases the probability of de-risking.

Weakened policy and regulatory environment. A weakening of state capacity because of corruption and rent-seeking activity has negative consequences for a country's policy and regulatory environment, which is an important driver of capital flows, as it serves as an indicator for the ease of doing business domestically. It may also lead to de-risking. This is particularly true in the case of AML-CFT policy. Countries that have weak AML-CFT regimes are highlighted by the FATF following a mutual evaluation[22]. Poor FATF ratings are accompanied by poor risk perceptions by the business players within and outside a jurisdiction. In some cases, countries may even be grey-listed. This is a red flag in terms of compliance risk for correspondent banks, who are likely to immediately de-risk banks within the jurisdiction. As discussed, such de-risking

22 https://www.fatf-gafi.org/publications/mutualevaluations/documents/assessment-ratings.html

may marginalise already fragile economies, threaten remittance channels and foreign direct investment, and drive financial flows underground, thereby further generating IFFs (IMF, 2018).

In short: IFFs reduce the flow of legitimate capital through hubs and spokes. Weaknesses in a jurisdiction's AML-CFT frameworks and the risk of IFFs lead to de-risking. De-risking, in turn, cuts countries off from capital flows, which again fosters the use of less regulated channels through which to access capital.

4. Conclusion and way forward

Cycle of de-risking and IFFs curbing capital flows and undermining economic growth. This note considered the interplay between de-risking, IFFs and capital flows in the context of regional hubs in Africa. It is apparent from the discussion that the concepts of IFFs and de-risking are interrelated and that these present a significant challenge for the continent. The discussion has shown that, although individual institutions may perceive de-risking to be an easy way to boost AML-CFT compliance for their businesses, it eventually could worsen AML-CFT risk and create a vicious cycle whereby IFFs may in fact be exacerbated. IFFs, in turn, trigger de-risking, thereby reinforcing the cycle. This de-risking-IFF cycle negatively affects the flow of legitimate capital to productive sectors of the economy and, through that, has negative implications for economic fundamentals in Africa.

Hubs spreading and reinforcing the impact in the region. The de-risking-IFF cycle is reticulated via the hubs into spoke countries. When hubs are de-risked due to perceived risks in these jurisdictions, spokes lose out on crucial gateways through which legitimate capital can flow into their economies. This can lead to spokes using countries that have less robust AML-CFT frameworks as avenues through which to obtain capital, which can lead to a rise in IFFs. Hubs can also be IFF centres, with IFFs spreading from hubs into spokes. This can likewise have negative economic and development outcomes, not only in the hubs but also in spoke countries.

Work in regional economic hubs to help address IFFs and de-risking challenges. Poor mutual evaluation scores on AML-CFT suggest that IFFs remain a systemic challenge in Africa. Working in the hubs may present the best chance of addressing this challenge and enhancing the integrity of Africa's financial sector, as they play an important role in channelling capital into spoke countries and can influence policymaking, regulation and compliance practices. Regulators and supervisors in hub countries with robust AML-CFT frameworks can take the lead in helping to address challenges of de-risking and IFFs by providing technical assistance and sharing information on compliance best practices with their counterparts in spoke countries. Regulators in hubs can also help to shape region-wide frameworks for robust AML-CFT guidance and compliance. This can be particularly important during a crisis (such as the COVID-19 pandemic), which is likely to result in tighter financing conditions across the globe and reduced risk appetite by banks, which could result in de-risking.

It is in the hub and spoke economies' direct interest that the region as a whole has a lower risk of IFFs, has effective and coordinated approaches to risk management and that both the hubs and spokes are more attractive to formal capital flows. Regions share the same fate, and only those that are effective at IFF risk management will be able to escape the spiral of nominal compliance, risk complacency or non-awareness, IFFs, de-risking and IFFs leading to economic disruption and degradation.

By working together, hubs and spokes can improve regional risk information-sharing, help conduct regular country assessments, reduce the cost of compliance, employ innovative AML-CFT measures and enhance governance. This will help to bolster capital flows, leading to more buoyant economies and higher levels of individual welfare.

Based on these findings, we propose a number of recommendations to address specific challenges associated with de-risking and IFFs, as outlined below.

Strengthen financial integrity in regional African hubs

Creating robust financial sectors in the hub economies in Africa will reduce de-risking and its associated effects in the region and is essential for sustainable development. As such, work should be done within hub economies to strengthen the stability and integrity of their financial systems. Specific interventions in hub economies could include:

- Technical assistance to financial intelligence centres in hub economies to improve their capacity to coordinate the country's approach to AML-CFT, including its ability to detect and combat IFFs
- Research into the legal frameworks for AML-CFT in hub economies and further technical assistance spearheaded by the donor community to improve legal frameworks for AML-CFT in hub countries and to address key gaps
- Training for AML-CFT supervisors on risk-based supervision (Particular focus should be placed on financial exclusion risk and ensuring that such risk is considered within institutional risk assessment frameworks.)
- At the global level, institutions should be expected to justify de-risking activity based on genuine ML-TF risk.

Limit unnecessary de-risking in hubs

- Improving cooperation and coordination between regulators in developing markets and the regulators of correspondent banks in developed markets, as well as between these parties and global standard-setters, to find regulatory solutions that meet the requirements of all parties
- Establishing supervisory colleges between developed and developing-country markets to create ongoing dialogue between countries on AML-CFT issues and implementations that can reduce de-risking (this could be facilitated by the regional FATF bodies responsible for appropriate implementation of the 40 recommendations in their respective regions.)
- Implementing a regional regtech solution in a hub country in Africa with AI capabilities to detect and track IFFs in real time throughout the region. This will provide more clarity on real AML-CFT risks and reduce unnecessary de-risking where risk is unclear. It will also improve combatting of financial crime and therefore lower the level of risk over time

Improve information-sharing and availability of data for risk interpretation

Since de-risking is in part driven by a lack of access to granular data that can assist organisations in making the correct decision, more needs to be done to ensure that such information is readily available to institutions. The following specific actions should be taken:

- Correspondent banks should improve information-sharing with respondent banks in hub countries on transactions they find concerning, so that respondent banks can assess whether their risk perceptions align.
- Countries should consider publishing their national risk assessments. Doing so would demonstrate their commitment to AML-CFT and inform outsiders of the risks they face

and how they intend to address them. This will also provide correspondent banks with more information on risk products, areas and activities within the region.

- Correspondent banks should be encouraged to make full use of the risk-based approach, to identify the kind and level of risks faced in certain jurisdictions or by certain respondent banks[23]. Supervisors of respondent banks should provide information on risk profiles and how higher risks are being addressed. This is particularly crucial during the COVID-19 pandemic where payment channels are necessary to facilitate the flow of money to people in need. The FATF has explicitly endorsed the use of the simplified due diligence measures available to institutions during the COVID-19 pandemic (where appropriate). Financial institutions should take advantage of this flexibility when considering retail consumers.
- Regional bodies should gather data on de-risking and IFFs that can be used to monitor trends in de-risking and to help build robust risk assessment systems.

Use regtech (regulation technology) to track IFFs and to reduce compliance cost

Technology will be a key enabler of the effective implementation of the risk-based approach to AML-CFT. It improves the understanding of risk, reduces compliance cost and can track and identify IFFs in real time. In addition to the establishment of a regional regtech hub, countries should consider implementing their own regtech solutions for IFFs where capacity and funding sources are available. In addition:

- Respondent and correspondent banks should make full use of shared (CDD) utilities to reduce the burden of compliance with customer due diligence requirements. The due diligence of correspondent banks should consider the robustness of the CDD process to effectively manage risk and not be a mere compliance check aligned with the correspondent host country.
- Banks should explore and implement digital identity and biometrics in CDD processes that reduce onboarding costs while also reducing risk. This is urgent during the COVID-19 crisis – the FATF has explicitly encouraged "the use of technology, including fintech, regtech and suptech to the fullest extent possible" during the crisis.
- Regulators can help to create a supportive regulatory environment that fosters innovation in new forms of customer identification to reduce the administrative and compliance burden for institutions while improving effective ML-TF risk management. However, alignment and coordination between local and international regulators are essential to ensure regulatory implementations have the desired impact and that more effective measures do not regress to ineffective compliance regimes.

Capacity building

- Hub countries can support capacity-building programmes in high-risk, low-capacity spoke countries to strengthen the capacity of state institutions, regulators and supervisors to reduce ML and TF risks and achieve AML-CFT compliance.
- Financial institutions in hubs can provide technical assistance and guidance to those in spoke countries to enhance best-practice approaches to de-risking and IFFs.
- Regional bodies such as ESAAMLG can be used to coordinate actions to assess risks and address challenges of de-risking and IFFs.

23 Developed market jurisdictions can hold correspondent banks that they deal with tightly to account for any de-risking during COVID-19 pandemic that is not based on risk-based approach

Bibliography

Adam C., Jones E., & Woods N. 2015. High-Level Roundtable on Africa and New Global Finance: Macroeconomic Policy and Regulatory Responses. Global Economic Governance Program, University of London.

Ajayi, S. I. & Ndikumana, L. 2014. Capital Flight from Africa: Causes, Effects and Policy Issues. Oxford: Oxford University Press.

Alba, J., Hur, J., & Park, D. 2010. Do Hub-and-Spoke Free Trade Agreements Increase Trade? A Panel Data Analysis. Working Papers on Regional Economic Integration 46, Asian Development Bank.

Alliance for Financial Inclusion. 2011. Global Standard Setting Bodies and Financial Inclusion- Insights from Five Countries: Brazil, Kenya, Mexico, the Philippines and South Africa. Available at: https://www.gpfi.org/sites/gpfi/files/documents/Global%20Standard%20Setting%20Bodies%20and%20Financial%20Inclusion.pdf

Alliance for Financial Inclusion. 2015. Striking the balance: De-risking and SME finance in light of Basel III. Available at: https://www.afi-global.org/blog/2015/07/striking-balance-de-risking-and-sme-finance-light-basel-iii

Almeida, R. & Fernandes, A.M. 2008. Openness and Technological Innovations in Developing Countries: Evidence from Firm-Level Surveys. The Journal of Development Studies, 44:5, 701-727, DOI: 10.1080/00220380802009217

Artingstall, D., Dove, N., Howell, J., & Levi, M. 2016. Drivers & Impacts of Derisking: A Study of Representative Views and Data in the UK, by John Howell & Co. Ltd. for the Financial Conduct Authority. Surrey: John Howell & Co. Ltd. Available at: https://www.fca.org.uk/publication/research/driver

Asian Development Bank. 2015. 2015 Trade Finance Gaps, Growth, and Jobs Survey. Available at: https://www.adb.org/publications/2015-trade-finance-gaps-growth-and-jobs-survey

Association of Supervisors of Banks of the Americas. 2017. An Overview on De-risking: Drivers, Effects and Solutions. Available at: http://www.asbasupervision.com/es/bibl/i-publicaciones-asba/i-2-otros-reportes/1598-an-overview-on-de-risking-drivers-effects-and-solutions/file

Balassa, B. 1994. The Theory of Economic Integration: An Introduction. In: Nelsen B.F., Stubb A.CG. (eds) The European Union. Palgrave, London

Baldwin, R., Braconier, H., & Forslid, R. 2005. Multinationals, Endogenous Growth, and Technological Spillovers: Theory and Evidence. Available at: https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1467-9396.2005.00546.x

Bank for International Settlements. 2019. CPMI Quantitative Review of Correspondent Banking Data. Available at: https://www.bis.org/cpmi/paysysinfo/corr_bank_data.htm

Barro, R.J., & Sala-i-Martin, X. 1997. Technological Diffusion, Convergence, and Growth. Journal of Economic Growth. Available at: https://doi.org/10.1023/A:1009746629269

Bernard, B.A., Moxnes, A. 2017. Networks and Trade. Annual Review of Economics 2018 10:1, 65-85

Blackenberg, S & Khan, M. 2012. The Political Economy of Illicit Flows. In: Draining Development? Controlling Flows of Illicit Funds from Developing Countries. Washington DC: The World Bank, pp. 19–109.

Buchan, N. R., Fatas, E., & Grimalda, G. 2012. Connectivity and Cooperation: The Oxford Handbook of Economic Conflict Resolution, edited by R. Croson and G.E. Bolton. Oxford: Oxford University Press.

Campos, N.F., Coricelli, F. & Moretti, L. 2015. Norwegian Rhapsody? The Political Economy Benefits of Regional Integration. CEPR Discussion Paper 10653. Available at: https://ssrn.com/abstract=2619188

Cassis, Y. & Bussiere, E. 2005. London and Paris As International Financial Centres in the Twentieth Century. (first ed.). Oxford: Oxford University Press.

Centre for Global Development. 2018. How Illicit Finance Controls Can Make It Harder for Non-profits to Serve the World's Neediest —and What to Do about It. Available at: https://www.cgdev.org/blog/how-illicit-finance-controls-can-make-it-harder-nonprofits-serve-world-neediest-and-what-do

Centre for Financial Inclusion. 2016. Who Is to Blame for Global De-Risking? The United States? Available at: https://www.centerforfinancialinclusion.org/who-is-to-blame-for-global-de-risking-the-united-states

Centre for Global Finance. 2018. Financial Inclusion and Economic Growth: What Do We Know? Working Paper Series No.11 / 2018. Available at: https://static1.squarespace.com/static/5aeb20ab297114b0c238a685/t/5ba3c9858165f5c3a1ddf7c6/1537460617927/WP+11_2018.pdf

Chaney, T. 2018. The Gravity equation in international trade: An explanation. Journal of Political Economy, vol 126(1), pages 150-177.

Charity & Security Network. 2017. Financial Access and De-Risking: Moving Toward Solutions for Non-profit Organizations. Available at: https://www.charityandsecurity.org/system/files/2017%20Fin%20Access%20Issue%20Brief docx_0.pdf 08

Cobham, A. 2015. Illicit Financial Flows Assessment Paper: Benefits and Costs of the IFF Targets for the Post-2015 Development Agenda. Available at: https://www.copenhagenconsensus.com/sites/default/files/iff_assessment_-_cobham_0.pdf

Cohen, G. 2019. Credit Where Credit is Due, De-Risking Africa's SMEs to Spur Private Sector Growth. Available at: https://asokoinsight.com/content/developments/derisking-africa-smes

Cooper, B., Rusare, M., van der Linden, A. & Ferreira, M. 2018. Illicit Financial Flows, A Financial Integrity Perspective. Available at: https://cenfri.org/wp-content/uploads/2018/09/Illicit-financial-flows_Cenfri-FSDA_September-2018.pdf

De Lombaerde, P., Van Langenhove, L., Raschdorf, A.-C., Iapadre, P., Gaulier, G., Jean, S., Ünal, D., Woolcock, S., Costea, A.-C., Villaverde, J., Pédussel, J W., Best, E., Blagescu, M., Lloyd, R., Tavares, R. & Schulz, M. 2006. Assessment and Measurement of Regional Integration. Routledge. London-New York.

Durner, T. & Shetret, L. 2015. Understanding Bank De-risking and Its Effects on Financial Inclusion. Available at: https://www-cdn.oxfam.org/s3fs-public/file_attachments/rr-bank-de-risking-181115-en_0.pdf

Eastern and Southern Africa Anti-Money Laundering Group. 2017. Survey Report on De-Risking in the ESAAMLG Region. Available at: https://esaamlg.org/reports/ESAAMLG_survey_reports_on_de%20_risking.pdf

El Agraa, A.M. 1989. The Theory and Measurement of International Economic Integration. London: Macmillan, 1989, p.9.

Elliott, D.J., & Yu, Q. 2015. Reforming Shadow Banking in China. Available at: https://www.brookings.edu/wp-content/uploads/2016/06/Elliott-Shadow-Banking-2.pdf

Esen, S. & Gokmenoglu, K. 2016. Financial Centres Index and GDP Growth. Available at: http://www.ccsenet.org/journal/index.php/ijef/article/view/57557

Fanelli, M.J. 2008. Macroeconomic Volatility, Institutions and Financial Architectures: The Developing World Experience. Basingstoke [England]; New York: Palgrave Macmillan, 2008.

Financial Action Task Force (FAFT). 2012. Specific Risk Factors in Laundering the Proceeds of Corruption. Available at: http://www.fatf-gafi.org/media/fatf/documents/reports/Specific%20Risk%20Factors%20in%20the%20Laundering%20of%20Proceeds%20of%20Corruption.pdf

Financial Action Task Force (FAFT). 2014. FATF Clarifies Risk-Based Approach: Case-by-Case, Not Wholesale De-Risking. Available at: https://www.fatf-gafi.org/documents/documents/rba-and-de-risking.html Financial Action Task Force (FAFT). 2019. Money Laundering. Available at: https://www.fatf-gafi.org/faq/moneylaundering/

Financial Actional Task Force (FAFT). 2019. Money Laundering. Available at: https://www.fatf-gafi.org/faq/moneylaundering/

Financial Stability Board (FSB). 2017. FSB Action Plan to Assess and Address the Decline in Correspondent Banking, Progress Report to G20 Summit of July 2017. Available at: https://www.fsb.org/wp-content/uploads/P040717-3.pdf

Fjeldstad, O.H., Jacobsen, S., Ringstad, P., & Ngowi, H. (2017). Lifting the Veil of Secrecy: Perspectives on International Taxation and Capital Flight from Africa.

Fleming, L. King III, C. & Juda, A. 2006. Small Worlds and Regional Innovation. Organization Science. 18. 10.2139/ssrn.892871.

Forstater, M. 2018. Illicit Financial Flows, Trade Misinvoicing, and Multinational Tax Avoidance: The Same or Different? Policy Paper 123. Centre for Global Development

Global Financial Integrity. 2017. Illicit Financial Flows to and from Developing Countries: 2005- 2014: Creative Commons Attribution License.

Global Financial Integrity. 2020. Illicit Financial Flows. Available at: https://gfintegrity.org/issue/illicit-financial-flows/

Global Justice Now. 2017. The Honest Accounts 2017: How the World Profits from Africa's Wealth. Available at: https://www.globaljustice.org.uk/sities/default/files/files/resources/honest_accounts_2017_web_final_updated.pdf

Graham, B. S. 2015. Methods of Identification in Social Networks. Annual Review of Economics, 2015, 7, 465–485.

Haisen, H & Yazdifar, H. 2015. Impact of the Shadow Banking System on Monetary Policy in China. ICTACT Journal on Management Studies. Volume 1. Issue 1 – February 2015.

Hatayama, M. 2019. The Role of Regional Financial Centres for Development Finance. Available at: https://assets.publishing.service.gov.uk/media/5ca20a3340f0b625e1cbd86e/522_The_Role_of_Regional_Financial_Centres_for_Development_Finance.pdf

Huang, D.S., Huang Y.-Y., & Tsay, C. 2018. On the Determinant of Trading Hub in East and Southeast Asia: Theory and Empirical Evidence. IEAS Working Paper: Academic Research 18-A007, Institute of Economics, Academia Sinica, Taipei, Taiwan.

International Association of Money Transfer Networks. 2020. Impact of COVID-19 on Migrants and Remittances. Available at: https://www.iamtn.org/impact-of-covid19

IFC. 2016. Mitigating the Effects of De-Risking in Emerging Markets to Preserve Remittance Flows. Available at: https://www.ifc.org/wps/wcm/connect/45fa0bf6-2ed2-4c57-9ada-298d1eb96c53/Note+22+EMCompass+-+DeRisking+and+Remittances++FINAL.pdf?MOD=AJPERES&CVID=lwwldO4

International Monetary Fund. 2000. Offshore Financial Centres. IMF Background Paper. Available online at: https://www.imf.org/external/np/mae/oshore/2000/eng/back.htm

International Monetary Fund. 2018. Age of Insecurity, Rethinking the Social Contract. Finance & Development, December 2018, VOL. 55, No. 4

Jordaan, J.C. 2010. Foreign Direct Investment and Neighbouring Influences. Unpublished doctoral thesis, University of Pretoria, South Africa.

Jubilee Debt Campaign. 2017. The Honest Accounts 2017: How the World Profits from Africa's Wealth. Available at: http://africagrantmakers.org/resource/honest-accounts-2017-world-profits-africas-wealth-pdf-2017/

Kaur, B. 2019. Foreign Direct Investment: A Growth Engine for Tourism. Available at: https://ssrn.com/abstract=3385163

Keller, L. & Chowdhury, I. 2012. Managing Large-Scale Capital Inflows; The Case of the Czech Republic, Poland and Romania. IMF Working Papers 12/138, International Monetary Fund.

Krugman, P. 1991. Geography and Trade. Cambridge, MA: MIT Press, 1991, p. 98.

Langthaller, J. & Nino, J.L. 2017. An Overview on De-risking: Drivers, Effects and Solutions. Association of Supervisors of Banks of the Americas. Available at: http://www.asbasupervision.com/es/bibl/i-publicaciones-asba/i-2-otros-reportes/1598-an-overview-on-de-risking-drivers-effects-and-solutions/file

Le Billon, P. 2011. Extractive sectors and illicit financial flows: what role for revenue governance initiatives? U4 Issue. Available at: https://www.cmi.no/publications/file/4248-extractive-sectors-and-illicit-financial-flows.pdf

MENAFAFT. 2019. MENAFATF Morocco Mutual Evaluation Report – 2019. Available at: http://www.fatf-gafi.org/publications/mutualevaluations/documents/mer-morocco-2019.html

Mhlanga, N., & Christy, R.D. 2006. Capital Flows to Africa: An Analysis of the Structure of Official and Private Capital Flows. Working Papers 127057, Cornell University, Department of Applied Economics and Management.

Ndikumana, L., & Boyce, J. K. 2012 Capital Flight from Sub-Saharan African Countries: Updated Estimates, 1970-2010. Available at: http://dx.doi.org/10.2139/ssrn.2202215

Ndikumana, L. 2016. Trade Misinvoicing in Primary Commodities in Developing Countries: The cases of Chile, Cote d'Ivoire, Nigeria, South Africa and Zambia. Geneva: UNCTAD

Obstfeld, M. 2007. International Finance and Growth in Developing Countries: What Have We Learned? Berkeley: University of California.

OECD. 2009. Money Laundering Awareness Handbook for Tax Examiners and Tax Auditors. Available at: http://www.oecd.org/ctp/crime/money-laundering-awareness-handbook-for-tax-examiners-and-tax-auditors.pdf

Owen-Smith, J. & Powell, W. 2004. Knowledge Networks as Channels and Conduits: The Effects of Spillovers in the Boston Biotechnology Community. Organization Science – ORGAN SCI. 15. 5-21. 10.1287/orsc.1030.0054.

Reuter, P. 2012. Draining Development? Controlling Flows of Illicit Funds from Developing Countries. Washington, DC: World Bank.

South African Reserve Bank. 2014. Financial Stability Review. Pretoria: South African Reserve Bank

Tax Justice Network. 2019. Vulnerability and Exposure to Illicit Financial Flows risk in Africa. Available at: https://www.taxjustice.net/wp-content/uploads/2019/08/Vulnerability-and-Exposure-to-Illicit-Financial-Flows-risk-in-Africa_August-2019_Tax-Justice-Network.pdf

Tax Justice Network. 2020. Financial Secrecy Index-2020.

Thom, M., Cooper, B., Weideman, J., Coetzee, W., Gray, J., Hougaard, C., & Plessers, H. 2016. Making Access Possible (MAP) DRC. Cenfri, FinMark Trust, UNCDF, Cether.

Tinbergen, J. 1962. An Analysis of World Trade Flows, in Shaping the World Economy. New York, NY: Twentieth Century Fund

UNCTAD. 2006. Trade and Development Report, 2006.

UNECA. 2015. Report of the High-Level Panel on Illicit Financial Flows from Africa, commissioned by the AU. In ECA Conference of Ministers of Finance, Planning and Economic Development.

UNECA. 2018. A Study on the Global Governance Architecture for Combating Illicit Financial Flows. Available at: https://www.uneca.org/sites/default/files/PublicationFiles/global-governance_eng_rev.pdf

Vorobyeva, Y. 2018. Drivers of Illicit Financial Flows. United Nations Interregional Crime and Justice Research Institute. Available at: http://unicri.it/in_focus/files/IFF_report_web.pdf

World Bank. 2018. Migration and Remittances: Recent Developments and Outlook–Transit Migration. Migration and Development Brief 29. World Bank, Washington, DC

World Trade Organisation. 2019. Trade Finance and the Compliance Challenge – A showcase of international cooperation. Available at: http://documents.worldbank.org/curated/en/736471567750290277/pdf/Trade-Finance-and-the-Compliance-Challenge-A-Showcase-of-International-Cooperation.pdf

Annexure

Stakeholder consultations

Name	Institution/role
James Edeh	Compliance Officer at Providence Bank Ghana
Jared Osoro	Director of research at Kenya Bankers Association (KBA)
Louis de Koker	Professor of Law at La Trobe University
John Symington	Founder and director at Compliance and Risk Resources
Raymond Paola	South African Reserve Bank (SARB)
Robert Bell	Founder of KlickEx – payments provider
William Artingstall	Director at a multinational bank – participated in personal capacity
William Odoom	Head of Compliance at UBA bank Ghana

Table 2: Stakeholder consultations

Cenfri, Cape Town, South Africa
infor@cenfri.org
@cenfri_org
www.cenfri.org

FSD Africa, Nairobi, Kenya
info@fsdafrica.org
@FSDAfrica
www.fsdafrica.org

Department of International Development
enquiry@dfid.gov.uk
@DFID_UK
www.gov.uk

About Cenfri
Cenfri is a global think-tank and non-profit enterprise that bridges the gap between insights and impact in the financial sector. Cenfri's people are driven by a vision of a world where all people live their financial lives optimally to enhance welfare and grow the economy. Its core focus is on generating insights that can inform policymakers, market players and donors who seek to unlock development outcomes through inclusive financial services and the financial sector more broadly.

About FSD Africa
FSD Africa is a non-profit company that aims to increase prosperity, create jobs and reduce poverty by bringing about a transformation in financial markets in sub-Saharan Africa (SSA) and in the economies they serve. It provides know-how and capital to champions of change whose ideas, influence and actions will make finance more useful to African businesses and households. It is funded by the UK aid from the UK Government. FSD Africa also provides technical and operational support to a family of 10 financial market development agencies or "FSDs" across SSA called the FSD Network.