

27 February 2001

The Manager

Dear Sir/Madame

In order to ensure the maintenance of the integrity of the financial system and of financial institutions in the Eastern Caribbean Currency Union, we have been instructed by the Monetary Council of the Eastern Caribbean Central Bank to issue the attached Prudential Guidelines relating to the control of large credit exposures.

Your institution is requested to adhere to these guidelines which are in keeping with International Prudential Practices.

Yours faithfully

K Dwight Venner
GOVERNOR

KDV/

cc Financial Secretaries/Directors of Finance
Resident Representatives

Att

PRUDENTIAL GUIDELINES

CONTROLLING RISK IN CORRESPONDENT ACCOUNTS

Correspondent relationships are an integral part of banking operations in an increasingly globalized environment. It provides a vehicle for the interface of the domestic financial system with that of the rest of the world. This access to the international financial system is of critical importance to small open economies, facilitating the trading activities of economic agents. Correspondent banking is of particular importance to indigenous banks, as through this medium these banks are able to provide international services to their customers. This would otherwise be unavailable, in the absence of a global network of branches.

Correspondent banking, like many other bank operations, is inherently risky. Correspondent banks are particularly vulnerable to serious counterparty risks, such as reputational, operational and legal risks. The awareness of these risks has become more heightened in recent times with the intensification of counter-money laundering activities internationally. This has been manifested in the Financial Action Task Force (FATF)'s inclusion of some of the Member States of the currency union in the list of 'non-cooperative jurisdictions' published in June 2000, and the resulting financial advisories issued by the US and Canada.

Correspondent banks typically attempt to control these risks through a number of know-your-customer practices that include policies and procedures for customer acceptance, customer identification, on going monitoring of high risk accounts and a risk management program. One of the key elements in a correspondent bank's customer acceptance policies is the regulatory and supervisory regime to which the respondent or customer bank is subject. Considerable reliance is placed on the correspondent's assessment of the regulatory agency, and the reputation of the Central Bank is a prime factor in the decision to accept a bank from this jurisdiction as a customer. The correspondent banks due diligence exercises, however, are compromised where the respondent bank provides access to their services to third party financial institutions that are not subject to a similar process. This facilitation by way of 'nested' correspondent accounts could potentially expose the correspondent to undue risk, making the otherwise acceptable bank a high risk.

Another area of concern is the maintenance of accounts for offshore gaming entities. These entities, by virtue of their illegitimacy in most of the United States and the vast amounts of money they generate, pose a major counterparty risk to banks that operate their accounts. There is a strong potential for money laundering charges to be levied against these banks, particularly if these funds pass through their accounts with US correspondent banks. The publication in February 2001 of a US Senate Subcommittee's report on 'Correspondent Banking: A Gateway to Money Laundering' has identified institutions in the Currency Union that "nested" high risk entities in their correspondent accounts, thereby providing these entities with access to the US financial system.

These could jeopardise the relationship between the correspondent and respondent banks, and could lead to the association being severed. This could also lead to more severe consequences, such as

freezing of accounts and asset seizures. There is also the potential of collateral risk to the integrity of, and confidence in, the entire financial system in the Currency Union.

The Eastern Caribbean Central Bank, in cognisance of the importance of correspondent banking relationships to economic activity in the currency union, and of the risks posed to these arrangements by the operation of accounts for offshore entities that are subject to a different regulatory and supervisory framework, recommends that:

A financial institution shall not provide, or in any way facilitate, access to correspondent banking facilities to third-party financial institutions not licensed under the provisions of the Banking Act and/or supervised by the Eastern Caribbean Central Bank. Banks are also required to employ strict know-your-customer standards and exercise adequate due diligence, particularly in maintaining accounts for offshore entities, in order to minimise counterparty risks.

EASTERN CARIBBEAN CENTRAL BANK
MARCH 2001