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Do FCA de-risking warnings raise more questions than they answer?

Not only are financial institutions juggling anti-money laundering compliance with admonitions to avoid 'wholesale de-risking' – they also face competition law risks such as abusing a dominant position or anti-competitive agreements. More clarity is needed, urge **Guy Wilkes** and **David Harrison**.

The Financial Conduct Authority's waving of a competition stick at banks it accuses of inappropriate de-risking might have adverse effects on an industry that is already in a state of discomfort about the regulatory response to anti-money laundering (AML) failures. The FCA should tread carefully.

On 24 May 2016, the FCA published research it had commissioned into the issue of de-risking by banks. [1] At the same time it published the research (and in a thinly veiled threat) it warned banks that they are subject to competition law and, in particular, the prohibitions on anti-competitive agreements and abuse of market power.

However, the FCA did not elaborate on the sorts of behaviour it is concerned about. Further guidance would be of assistance.

What is de-risking?

De-risking is the withdrawal of banking services to customers in sectors or regions that a bank considers at present too high a risk of money laundering, terrorist financing or reputational damage.

The drivers that cause banks to de-risk can be complex and include:

i. a response to criminal, civil and regulatory actions arising from AML compliance failures;
ii. a desire to avoid the higher costs of compliance in dealing with higher–risk customers;
iii. a strategic decision to re–focus on core business; and
iv. a wish to avoid the reputational risks of dealing with higher–risk customers.

Regulatory response to de-risking

Following the financial crisis in 2008, regulators universally welcomed bank efforts to reduce risk in a whole range of areas, not limited to financial crime.

Dahabshiil money transfer service in London

Indeed, the FCA has itself required banks not to enter into business relationships where a bank does not believe that it can effectively manage the associated money-laundering risk. In its 2013/2014 annual report into money laundering the FCA reported that it had obtained voluntary undertakings from six banks, including a large UK institution, that they would not enter into certain types of high-risk relationships until AML control weaknesses had been corrected. It also noted with approval, that a small bank had decided to exit over 200 relationships where it could not satisfy itself that it could manage the risks these customers posed (although only two accounts involved suspicious activity).

However, around 2014 regulators, politicians and others in the UK and elsewhere began to realise that banks' efforts to reduce their exposure to regulatory risk might harm the economy and cause hardship to particular sectors of business or the community. Examples frequently cited include the withdrawal of banking to money service businesses (MSBs), charities operating in high-risk areas, home credit businesses and some fintech companies involved with alternative payments.

In 2015, the FCA finessed its approach to de-risking and told firms that a risk-based approach does not mean that banks should deal generically with whole categories of customers or potential customers. Instead, it expects banks to recognise that the risk associated with different business relationships in a single broad category varies, and to manage that risk appropriately.

In practice it is not so straightforward. As part of their AML controls, banks are expected to undertake a business-wide risk assessment to identify and assess the financial crime risks to which they are exposed as a result of, for example, the products and services they offer, the jurisdictions they operate in, the types of customer they attract, the complexity and volume of transactions, and the distribution channels they use to service their customers. The FCA then expects firms to allocate resources to the areas of greatest risk.

If, however, the revenue derived from a high-risk product line or sector is insufficient to justify the allocation of the necessary compliance resource, or the bank considers that local staff in a high-risk jurisdiction are insufficiently skilled or experienced to undertake enhanced due diligence (EDD) on higher-risk customers, then the sensible business response is to withdraw from that sector or region. No one can expect banks to continue doing business at a loss or carry levels of risk that are not justified by the revenue generated.

EDD for high-risk customers may in some cases simply involve the obtaining of additional information and evidence from customers (such as bank account statements evidencing source of funds or source of wealth) but in other cases it might be necessary to go as far as commissioning an intelligence report from a specialist provider – such reports can cost thousands of pounds and are clearly only justified for ultra-high net worth individuals or large corporates.

So far, the regulatory response to de-risking has involved providing informal guidance to banks, and disapproval of wholesale de-risking practices. Regulators including the FCA have recognised that their ability to force banks to provide services to customers they would rather not, is limited.

Competition law

However, in 2015, the FCA gained powers to enforce competition law and is looking at areas where it might flex its muscles. When publishing its research, the regulator stated: *"We note that banks, like all firms, are subject to competition law, in particular the prohibitions on anticompetitive agreements and abuse of market power contained in the UK Competition Act 1998, and in the Treaty on the Functioning of the European Union. They should be mindful of these obligations when deciding to terminate existing relationships or decline new relationships."*

To non-competition lawyers it might be counter-intuitive that an enterprise can breach competition law by refusing to take on new customers or ditching existing ones. However, there is ample precedent.

Abuse of dominant position (market power)

Under certain circumstances a refusal to supply goods or services by a company enjoying a dominant position in a market can be considered abusive. Cases frequently involve vertically integrated dominant firms refusing to do business with competitors. For example in the leading case of *Commercial Solvents Corporation*, [2] the sole manufacturer of a raw material used for the manufacture of ethambutol refused to supply a customer that wished to compete with it and was adjudged to have abused its dominant position. [3]

It is not difficult to see how the principle applies to financial services, since vertically integrated firms can and do supply services to competitors (correspondent banking, custody arrangements and the provision of banking to disruptive fintech companies are good examples). In the 2004 case of *Clearstream Banking AG*, [4] the sole provider of primary clearing and settlement services for securities issued under German law was found by the European Commission to have abused its dominant position in the market by refusing to supply primary clearing and settlement services to a competitor, Euroclear, for two years and then charging higher prices for its services than those charged to other customers.

It is not necessary for the conduct to have an anti-competitive objective in order for refusal to supply to be abusive – if refusal to supply could 'tend' to restrict competition, or 'is capable' of having that effect then that might be sufficient. However, a dominant firm's conduct may be justified by 'objective necessity' if the conduct in question is indispensable and proportionate to the goal allegedly pursued by the dominant undertaking.

A refusal to supply based upon a genuine need to reduce the risk of money laundering might be good justification for terminating services to a customer but care is needed in implementing the policy if it is not to fall foul of competition law.

In the context of de-risking the only attempt to invoke competition law in the UK so far involved an MSB, Dahabshiil Transfer Services, which provided services to customers wishing to transmit monies to Somalia. Money transfer businesses are considered in guidance published by the UK's Joint Money Laundering Steering Group (JMLSG) to be higher risk for money laundering and Barclays Bank sought to exit a number of such relationships, including Dahabshiil. Dahabshiil successfully obtained an interim injunction temporarily suspending the termination of its account. The judge stated that it was arguable that Barclays had a dominant position in the relevant sector in which Dahabshiil operated and that Barclays' defence of justification was only suitable for determination at trial. The case settled before that trial.

What is clear is that banks that might enjoy a dominant position in a market (solely or jointly with other banks) should take competition law advice and ensure that any de-risking strategy is fully compliant with competition law. It is also prudent that a bank's method of exit does not increase the money laundering risk unnecessarily (for example by agreeing to remit balances to third-party accounts).

Prohibition on anti-competitive agreements

What is less clear is in what circumstances a de-risking strategy might fall foul of the prohibition on anti-competitive agreements. It is possible that the FCA had in mind cartels, which are a serious form of anti-competitive behaviour and involve two or more competitor firms agreeing, whether formally or informally, to limit or cease competition between them. In a September 2015 publication 'Competition law and wholesale markets' [5] the FCA provides examples of cartel behaviour including *"price-fixing, market sharing, bid-rigging, limiting the supply or production of goods or services, or information exchange"*.

The FCA points out that *"the agreement or arrangement between competitors could be formed in many ways – including a written contract, a conversation over the phone or at a social event, a meeting or chat room, or via emails"*.

In its May de-risking publication the FCA does not disclose what it has in mind when it referred to anti-competitive agreements. The danger is that firms might be dissuaded from engaging in beneficial and helpful behaviours because of the risk of being accused of colluding or communicating with competitors.

For example, a welcome and vital development in the fight against financial crime and money laundering is the increased sharing of information and intelligence between banks, law enforcement and regulators. A good example is the Joint Money Laundering Intelligence Taskforce (JMLIT), which was set up for that purpose and involves 20 major UK and international banks, law enforcement and government agencies. Its aim is to "*analyse information and expertise in the public and private sectors to better understand the true scale of money laundering and the methods used by criminals to exploit the UK's financial system. It will then agree actions that stop it*". Participants are encouraged to share specific intelligence about suspected money laundering.

In its action plan for anti-money laundering and counter-terrorist financing published in April this year, the Home Office and HM Treasury have agreed to strengthen and build upon JMLIT pointing out that "*Effective exchange of knowledge within the private sector, and between the public and private sectors, is necessary to increase our collective knowledge of threats and vulnerabilities.*" The action plan proposes that there is a need for legal 'safe harbour' provisions "*to allow data and intelligence to be shared lawfully between financial institutions in order to prevent and detect money laundering and terrorist financing*".

In the United States a similar group of banks has been set up to counter human trafficking in cooperation with the Manhattan District Attorney's Office and there are proposals to extend this to cover AML in line with the JMLIT model.

However, the sharing of such information is pointless unless it leads to action (such as the closing of accounts or limiting services) and would be impossible if participants are dissuaded from doing so out of trepidation that they might be investigated for anti-competitive collusion.

One area of concern for banks might be the risk of straying inadvertently into cartel conduct, for example through discussions or agreements relating to:

i. dealing with certain customers or customer types (for example, an agreement not to deal with certain customers could constitute a 'collective boycott');
ii. withdrawal from a particular type of business; and
iii. criteria to be used in assessing risk.

The fact that banks may co-ordinate with a view to implementing requirements of government bodies would not necessarily preclude a competition law infringement, if their conduct were to go beyond the scope of the legitimate objectives of such co-ordination.

Perhaps the FCA has in mind anti-competitive arrangements that fall short of cartel behaviour but which nevertheless are unlawful. In its publication 'Competition law and wholesale markets' the regulator points out that agreements between a firm and its client that restrict the price and/or terms on which that client can resell a product, service or data could raise concerns.

The research published by the FCA on de-risking hinted (but did not explicitly state) that correspondent banking might present such a problem. The research highlighted that: *"several larger banks are sending medium or smaller banks lists of client types whose transactions they do not wish to process, or even those for whom they would prefer the smaller bank not to maintain an account. These lists include... MSBs and gambling..., and arguably constitute a form of wholesale derisking (by proxy) of client groups."*

However, the Money Laundering Regulations to which all UK banks are subject expressly provide that correspondent banking is to be regarded as higher risk. The correspondent has no direct relationship with the ultimate customers and is therefore not in a position to undertake due diligence on them or their transactions. For that very reason, when dealing with ultimate customers with which they have no direct relationship, it is impossible for correspondent banks to de-risk end users – they can only do it on a wholesale basis via the respondent bank.

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Further, such approaches appear to be consistent with JMLSG guidance. That guidance requires that correspondent banks assess a respondent's "*business and customer base*" on the basis that "*the type of business the respondent engages in, as well as the type of markets it serves is indicative of the risk the respondent presents*".

If the correspondent is not satisfied with that level of risk, or the respondent's ability to conduct EDD adequately on such customers, what is the correspondent to do? It can either refuse to do business with the respondent or else impose conditions on the type of business that the respondent engages in. Either option has the same effect for the end-customer.

From the perspective of compliance with the competition rules on restrictive agreements, it is important both for respondent banks and correspondent banks to ensure that their decisions on de-risking are taken unilaterally, ie independently of their competitors.

Summary

The FCA's reference to competition law and in particular anti-competitive agreements in its May 2016 guidance on de-risking has the potential to cause confusion and may have adverse consequences. While of course banks must comply with all laws (including competition law) it would be helpful if the FCA could elaborate on the types of de-risking it is seeing and which it believes may be problematic under competition law legislation.

Notes

[1] www.fca.org.uk/news/fca-research-into-the-issue-of-derisking.

[2] *Istituto Chemioterapico Italiano SpA and Commercial Solvents Corporation v Commission*, Joined Cases 6/73 & 7/73, 1974 ECR 223, [1974] 1 CMLR 309.

[3] Dominance has been defined under EU law as a position of economic strength enjoyed by an undertaking, which enables it to prevent effective competition being maintained on a relevant market, by affording it the power to behave to an appreciable extent independently of its competitors, its customers and ultimately of consumers (Case 27/76, *United Brands* [1978] ECR 461, paragraph 38).

[4] *Clearstream v Commission* T-301/04.

[5] www.fca.org.uk/static/fca/documents/comp-law-ws-markets.pdf.

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