

## Confronting the Challenge of Cross-Border Payments: A U.S. Strategy for Central Clearing KYC

Christina Parajon Skinner

### Abstract

For the past two years, the international community of financial regulators has been intently focused on improving the efficiency of cross-border payments. To date, this work has taken a wide lens in scoping the problem. This white paper focuses on what the U.S. could contribute to the cross-border payments initiative. It argues that the bulk of inefficiency in the current legacy system—correspondent banking—derives from frictions associated with anti-money laundering law and regulation. To streamline the process of conducting customer due diligence, specifically, the paper proposes moving toward a system of centralized verification. In particular, the paper sketches an idea for a new kind of payments market infrastructure—a centralized verifying party—that would act as a trusted, third-party intermediary verifying transacting parties within correspondent networks.



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## Confronting the Challenge of Cross-Border Payments: A U.S. Strategy for Central Clearing KYC

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**Abstract**—Central bank and financial policymakers are laser focused on modernizing cross-border payments. At the forefront of this debate are concerns about speed, cost, availability, and transparency—and, accordingly, the various sources of economic inefficiency that impact the end-users of this monetary infrastructure. And increasingly, cross-border payments implicate myriad other, highly pressing, financial policy questions—especially in the foreign policy and national security arenas. Russia’s invasion of Ukraine has highlighted the geopolitical importance of the payments systems rails, while China’s efforts to supplant the dollar caution against complacency with the dollar’s incumbency in global markets. Meanwhile, illicit finance continues to course through the global banking sector, including components of U.S. financial institutions, thereby undermining the United States’ interests in stemming the flow of finance to bad state and state-sponsored actors.

To date, the international community of central banks—working together through the Financial Stability Board—has made significant progress addressing the cross-border payments challenge. There is now significant opportunity for the United States to act unilaterally in order to move this workstream forward. In particular, by adopting a strategy that focuses on improving certain aspects of the anti-money laundering (“AML”) regime, U.S. policy could encourage the kind of market-driven institutional innovation that has potential to rapidly enhance the efficiency of cross-border payments while also serving broader U.S. national security goals.

Specifically, this paper urges a transition to a centralized system of customer due diligence conducted by a trusted, third-party intermediary known as a “centralized verifying party,” a “CVP.” Ultimately, moving toward a CVP model for AML due diligence shores up the legacy system of correspondent banking, perhaps reducing the attractiveness of nonbank payments alternatives like stablecoins (that sit outside the bank perimeter) or CBDC.

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## I. THE CROSS-BORDER PAYMENTS CHALLENGE

The flow of monetary payments across borders is now a significant and entrenched feature of the global economy. In 2021, 152% of global GDP—totaling over \$140 trillion flowed across borders. Projections of cross-border payments rise each year commensurate with the growing volume of international trade, e-commerce, and financial services transactions.<sup>1</sup> Consider the magnitude of international e-commerce alone—\$25.6 trillion globally in 2020 (up 8% from 2017); in fact, some estimate that fifteen to twenty percent of all global e-commerce value involves a cross-border (as opposed to domestic) transaction.

Indeed, almost every segment of the economy has some need for cross-border payments at one time or another—businesses (large and small) send money to other businesses (“B2B”) and consumers (“B2C”) abroad; and consumers who buy goods and services abroad necessarily send money to business (“C2B”) overseas as well. There is also a sizable flow of money from consumers in one jurisdiction to consumers in another; these retail-to-retail payments are known as “remittances.” For many citizens living abroad in emerging market economies, remittances from citizens in developed economies are a critical source of income (and, accordingly, a mechanism of global income redistribution).

But paying for goods and services outside of one’s nation-state is not a straightforward process. Currency is sovereign in its legal character; there is no global currency. Final settlement is also sovereign in its nature, as it takes place on the balance sheet of the central bank with central bank reserves. Settlement in central bank reserves makes a transaction “final” in the sense that any remaining credit risk is eliminated once settled with central bank reserves, which is presently the only form of money that completely lacks credit risk. But like currency, central banks are sovereign and there is no global central bank.

Herein lies an intractable dilemma for those wishing to make cross-border payments: a Bank operating in Country A does not have access to the balance sheet of central bank in Country B; consequently, Bank A cannot settle payments directly with customers in Country B. But private banks long ago devised a solution to this dilemma that is inherent in the lack of a global settlement asset (i.e., central bank money) or settlement system (i.e., a global central bank account). That is, banks devised a system to network themselves together, which is known as correspondent banking.

This white paper is organized in three parts. This first Part describes the correspondent banking system, its role in cross-border payments, and explains why one particular source of regulatory friction—surrounding anti-money laundering (“AML”)

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<sup>1</sup> *The Race to Redefine Cross-Border Finance*, ECONOMIST (Oct. 21, 2021), <https://www.economist.com/finance-and-economics/the-race-to-redefine-cross-border-finance/21805736>. This figure is projected to reach \$156 trillion this year. See Florian Seeh, *How New Entrants are Redefining Cross-Border Payments*, EY (Feb. 23, 2022), [https://www.ey.com/en\\_us/banking-capital-markets/how-new-entrants-are-redefining-cross-border-payments](https://www.ey.com/en_us/banking-capital-markets/how-new-entrants-are-redefining-cross-border-payments). The Bank of England estimates the value of cross-border payments to be over \$250 trillion by 2027. *Cross-Border Payments*, BANK OF ENG. (Dec. 2, 2021), <https://www.bankofengland.co.uk/payment-and-settlement/cross-border-payments>.

regulations—has contributed an outsized proportion of inefficiency to correspondent banking. Part II suggests efficiency and risk-management gains from introducing a new form of infrastructure to the payments market (within the correspondent banking system) and Part III briefly considers implications for stablecoin and CBDC.

### **A. Correspondent Banking: The Legacy Cross-Border Payment System**

Within the system of correspondent banking, private banks solve the problem of currency interoperability, that is, they overcome the sovereign character of money to facilitate its exchange across borders. To do this, domestic banks in Country A develop arrangements with foreign banking institutions whereby one bank (the correspondent) holds deposits owned by the other (the respondent). As one *Economist* article described it, “[t]he system of correspondent banking through which cross-border payments flow works like air transport: when two faraway banks do not have a direct relationship, money traveling from one to the other stops over at banks in between.”<sup>2</sup>

The correspondent bank provides financial services—especially and including payments services—to the respondent bank on an ongoing, relational basis. These payment services include wire transfers, check clearing, and foreign exchange settlement. In addition to providing a system to make currency interoperable, correspondent banks also supply liquidity in the market for foreign currency. Again, because currency is interoperable, currency A must be exchanged for currency B, if currency A is to be used to buy goods or services in country B (or for any other reason money from A is sent to B). The forces of supply and demand for each respective currency dictate the rate at which they are exchanged.

While U.S. banks developed rudimentary forms of correspondent banking domestically in the nineteenth century, as a model for facilitating cross-border payments, correspondent banking proliferated globally in the late 1960s and early 1970s. Around this time, governments globally recognized that correspondent banking services also served national interests in economic growth through cross-border financial activity. Tellingly, correspondent banking payments services were specifically protected in the 1994 World Trade Agreements. In summary, as the Basel Committee on Banking Supervision (“BCBS”) defined it in 2020,

Correspondent banking relationships allow banks to process cross-border payments without having a physical presence of legal domicile in other jurisdictions. This functionality provides a flexible and regulated channel with a potentially worldwide reach, thus supporting cross-border trade and investment, economic integration, and financial inclusion.<sup>3</sup>

Today, correspondent banking continues to play a central role in the global economy.

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<sup>2</sup> See *The Race*, *supra* note 1.

<sup>3</sup> RODRIGO COELHO ET AL., FSI INSIGHTS ON POLICY IMPLEMENTATION NO 28: CLOSING THE LOOP: AML/CFT SUPERVISION OF CORRESPONDENT BANKING 6 (2020).

Correspondent banking relationships are in many ways, however, diffuse and complex, which can introduce regulatory and risk management challenges. For one, correspondent banking arrangements can involve multiple financial institutions along what is known as a payment “corridor”—that is, the path from the payor (or originator) bank to the ultimate bank of the beneficiary. In cases where the originator bank and the beneficiary bank do not have a direct relationship that would allow them to settle payments directly, another institution known as an intermediary bank and its intermediary accounts enter the chain in order to settle the payment.<sup>4</sup>

The nature of the services provided by a correspondent bank also ranges in complexity and associated opacity. Traditional correspondent banking involves the opening and maintenance of an account for the respondent bank and subsequent processing of its payments transactions—in this arrangement, however, the customers of the respondent bank do not have direct access to the correspondent banking account. But there are variations on this standard arrangement. In cases of “nesting” relationships, the correspondent relationship is used by a number of downstream respondent banks. Other banks, “downstream” from the respondent, use their relationship with the respondent to access the financial services offered by the correspondent. “Pass by accounts,” meanwhile, are correspondent accounts used directly by third parties for transactions on their own behalf—in such cases a bank customer can write checks and make deposits in a foreign jurisdiction as if they were domestic account holders in that foreign jurisdiction.

If correspondent banking is like air transport, then the payments-passengers are almost all flying on one airline—Swift. Swift is a messaging system—the participating financial institutions agree to certain character strings to denote payments transactions—the terms of the transaction, the flight route (the path to which banks connect), and so on. Swift also then provides the secure network along which these messages can be sent between participating financial institutions. Developed in 1977, the Swift system revolutionized cross-border payments. Before Swift, banks wiring money overseas would use phone lines (not secure) and manual entry, which led to significant time and error. Now, over 500 banks participate in Swift and, according to best estimates, around 90% of cross-border payments flow through Swift.<sup>5</sup> Although Swift is decades old it is still modernizing. As of 2017, Swift has rolled out a global payments initiative, Swift gpi, which aims to improve the speed and transparency of these cross-border transactions—aiming to settle payments within one day.

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<sup>4</sup> The processing of a payment order by such an intermediary bank is known as a “cover” payment; for some time, cover payments suffered from a lack of transparency insofar as the intermediary would not always gain information about the originator and beneficiary in the course of processing the transaction.

<sup>5</sup> There are other payment rails available to banks for transmitting cross-border payments. ACH offers some limited cross-border services, as well as the Federal Reserve Banks. FedNow, the Fed’s realtime payments network due to roll out soon, will be domestic only initially. Cross-border payments can also be made via card transactions, through Visa, Mastercard, and American Express, though most of these cards are ultimately sponsored by banks which participate in the Swift network.

As the legacy system for facilitating the lion’s share of cross-border payments, the correspondent banking system has come under the policy microscope. Internationally, networking groups and standard setting bodies, like the G20 and the FSB, have begun to question whether this system is working as smoothly as possible—at optimal speed, cost, and accessibility.

## **B. The FSB Roadmap: The Multilateral Approach to Cross-Border Payments**

In 2020, the G20 made cross-border payments a policy priority, with emphasis on the “cost, speed, access, and [lack of] transparency” in legacy systems. In turn, the Financial Stability Board (“FSB”)—an international network of central banks—took this work forward by commissioning three stages of work to study the limitations presented by existing cross-border payments infrastructure and opportunities for reform.<sup>6</sup> The FSB focused both on the inefficiencies in cross-border payments and also on the quality of the consumer, as end-user, experience.

In Stage 1, the FSB scoped existing cross-border payment arrangements and identified challenges inherent in these transactions; in Stage 2 (together with the Committee on Payments and Market Infrastructure, a group subsumed within the Bank for International Settlements) the FSB identified various roadblocks to improving cross-border payments; and in Stage 3, the FSB laid out its official roadmap for overcoming the obstacles identified and moving the international community forward. Meanwhile, the Bank of England moved forward in parallel with its own study of cross-border payments and discussion of the existing “frictions” it related to the problems of high cost, slow speed, limited access, and low transparency. These various workstreams and reports identified several frictions that contributed to the identified problems with the speed, cost, access, and transparency of the cross-border payments process. In broad strokes, these frictions were discussed as follows:

*One*, that data exchanges involved in cross-border payments are cumbersome, because transaction information is not standardized across jurisdictions; consequently, automating the exchanges of information is not yet feasible. But relying on human data processing is relatively cumbersome and time consuming.

*Two*, there are vast and varying regimes of financial crime checks required by each jurisdiction to ensure that payments are not in fact the transfer of illicitly gained funds, that is, money that is being laundered through the banking system or being used to facilitate the financing of terrorism. The regulatory regimes designed to prevent such misuse of the financial system’s services are commonly referred to as “AML/CFT” rules and, as will be discussed, tend to be quite onerous and variable across jurisdictions. (AML will be used throughout, for brevity.)

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<sup>6</sup> Payments tend to fall under the remit of the central bank, both because central banks provide the final settlement asset (reserves) and because central banks are usually the regulator and supervisor of payments systems and the financial institutions that supply payments services.

*Three*, given the challenges of maintaining intraday liquidity in the cross-border context, prudent intermediaries tend to set aside significant amounts of liquid capital to manage settlement risk—that is, the risk that the payor will go bankrupt or insolvent before the transaction has become final, leaving the intermediary financially responsible.<sup>7</sup> Relatedly, given foreign exchange and residual settlement risks involved, banks are also incentivized to overfund their anticipated payments transactions. Banks, acting as intermediaries, thus tend to overcapitalize cross-border payments transactions to manage risk and ensure they can settle these transactions as quickly as possible. There are opportunity costs associated with tying up capital for these reasons.<sup>8</sup>

*Four*, the reports find that because there are high barriers to entering the cross-border payment business, banks—the legacy operators—have little incentive to be creative in finding opportunity to reduce these costs and delays.

In Stage 2, the FSB (in coordination with the CPMI) set out the “necessary elements” of a strategy for improving the efficiency of cross border payments. These recommendations—19 separate “building blocks”—were grouped into five focus areas (A-E). Focus areas A through D focused on improvements to the existing payments system—via correspondent banking—while focus area E urged exploration of emerging payments technologies, like stablecoin and CBDC. In broad strokes, the 19 building blocks involve multiple nodes of multilateral action and cooperation, including, for example, pursuing a common “vision” or approach to cross-border payments services, goals, and targets; aligning or coordinating regulatory, supervisory, information-sharing frameworks; harmonizing aspects of data exchange and media; exploring operational improvements to operating hours, reciprocal liquidity arrangements, and interlinking systems; and, finally, exploring stablecoin and CBDC pathways. This work is now being taken forward in line with different action items suggested by the FSB.

Building block 5 concerns AML. It refers to the goal of applying AML/CFT rules “consistently and comprehensively,” and is lodged under Focus area B which pertains to the coordination of regulatory, supervisory, and oversight frameworks. The Building Block thus rests on the idea of legal harmonization and ultimately aims for the development of standards of guidance “in order to remove obstacles and promote a more standardised use of new technologies for applying AML/CFT standards.”

Arguably, although the FSB put forward each of the 19 building blocks as equally deserving of policy attention, Building Block 5 *should be* a priority. The costs associated

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<sup>7</sup> This liability structure has existed, at least for U.S. banks, since the mid-nineteenth century and the advent of check and checkable deposits. See John A. James & David F. Weiman, From Drafts to Checks: The Evolution of Correspondent Banking Networks and the Formation of the Modern U.S. Payments System, 1850-1914, 24 J. MONEY, CREDIT & BANKING 237, 238-39 (2010). Checks are integrated into the U.S. payments space as a contingent liability of the payor’s bank, thereby exposing the bank to risk of liquidity shortfalls of the payor. *Id.* at 239.

<sup>8</sup> Payments related black swan events do happen. With perhaps greatest notoriety, in 1974, a privately owned bank in Germany—Herstatt Bank—received Deutsche Marks from banks around the world as part of transactions pursuant to which Herstatt would pay out U.S. Dollars during U.S. business hours. But before doing so, Herstatt declared bankruptcy and did not fulfill its U.S. Dollar transactions, leaving the counterparty institutions with significant losses to bear.

with AML rules appear to supply an outsized portion of the frictions that introduce the various inefficiencies identified in Stage 1. The balance of this paper explores how U.S. financial policy on cross-border payments could advance the international agenda by prioritizing AML and, in particular, incentivizing the development of market infrastructure that could drastically improve the current system for complying with one of the most onerous aspects of AML—customer due diligence.

### **C. Building Block 5: What are the Rules that Govern AML?**

Money laundering is a global problem. The UN Office on Drugs and Crime estimates that the amount of money laundered globally each year is about 2-5% of global GDP—according to IMF estimates this is about \$1.6-\$4 trillion annually. And correspondent banking is the key battleground for governments' fight against it. Accordingly, financial policy makers convene globally to set international standards of best practices for combatting money laundering, corruption, and terrorist financing. This group, the Financial Action Task Force ("FATF") supplies and updates recommendations which national governments are then encouraged to adopt in spirit. The lodestar of these recommendations where correspondent banking is concerned involves recordkeeping of transactions (recommendation 11), the reporting of suspicious transactions (recommendation 20), and customer due diligence (recommendation 10).

Like all international financial regulation, standards may be set internationally but they must be implemented and enforced domestically. The Bank Secrecy Act ("BSA") is the primary piece of legislation setting out banks' (and money service businesses') obligations to ensure that their services are not used for illicit purposes. When enacted in 1970, the BSA's initial purpose was to ensure that banks would have information about their customers (and their customers' transactions) that would enable them to provide law enforcement with information that would have a "high degree of usefulness." The BSA was later amended by the USA Patriot Act, but the essential purpose of the legislation remained the same.

The BSA broadly establishes reporting and recordkeeping requirements for any businesses covered by the statute. In particular, it requires covered institutions (mostly banks and MSBs) to file suspicious activity reports ("SARs") with FinCen in Treasury. FinCen is the U.S. government's financial intelligence unit and BSA enforcer. Its mandate, set out in the Patriot Act, provides that it should "support law enforcement efforts and foster interagency and global cooperation against domestic and international financial crimes, and . . . provide U.S. policy makers with strategic analyses of domestic and worldwide trends and patterns."<sup>9</sup> FinCen has broad rulemaking authority to implement and administer the BSA.

Banks are required to file a SAR with FinCen regarding any transactions of \$5,000 or more if the financial institution knows, suspects, or has reason to suspect that the

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<sup>9</sup> Treas. Order § 2, 67 Fed. Reg. 64697, 64697 (Oct. 21, 2002).



transaction might involve money laundering; is designed to evade the BSA; or has no business or apparent lawful purpose or is not the type in which the customer would be expected to engage. Because this analysis is in many ways subjective and highly fact and context specific, constructing these so-called SARs narratives is extremely time intensive for financial institutions to do.

But perhaps the most onerous aspect of AML compliance involves the customer due diligence component, referred to in the U.S. as “KYC” (“know your customer”). Patriot Act amendments to the BSA created requirements for covered firms to develop bespoke customer identification programs for the purposes of completing initial and, if needed, ongoing due diligence. KYC rules bind whenever a bank or payments processor establishes a new business relationship or whenever carrying out new kinds of transactions that could carry AML risk. Given the cross-border, intermediated nature of their business, correspondent banking networks are scrutinized particularly heavily by financial crime units like FinCen.

While there is no particular program for KYC proscribed by U.S. law, there are international best practices established by FATF. They suggest that KYC programs should enable robust risk management and that correspondent institutions should identify and verify the identity of respondent institutions using any and all reliable independent source information. Financial institutions are also recommended to understand fully the purpose and intended nature of the correspondent banking relationship, including, for example, the types of customers served, how robust is the related bank’s internal supervision, whether it has ever been the subject of AML investigations or sanctions, and whether the countries to whom correspondent banks are offering their services have adequate financial supervisory oversight in place.

The BCBS also provides some guidance on AML risk-management in the context of correspondent banking services. It urges banks to consider risks created where banking services are used by another bank’s affiliates, third parties, or through pass through accounts. It recommends that correspondent banks gather ample information about the characteristics, activities, markets, management, governance, and ownership of respondent banks. Beneficial ownership—shell companies—has come into particular focus of late. Correspondent banks need to take particular care that they have taken sufficient steps to identify the true ownership of any respondent institutions. Correspondents should know enough about the ownership and control structure of a respondent to ensure the institution is not a shell.

The BCBS and FATF have also issued supervisory guidance on transparency in cross border wires. Originating banks, according to this guidance, are “responsible” for requiring that full information on the originator and beneficiary accompanies all wires, and “encourages all banks to apply high transparency standards.” Further, these established best practices require that “the quality of information provided in payment messages [is] part of ongoing monitoring. . . the correspondent bank as an intermediary should monitor the payment messages transmitted by the respondent bank for the

purpose of detecting those which lack required originator and/or beneficiary information, including meaningless fields.”<sup>10</sup>

FinCen asks banks to engage in a “cooperative partnership” by agreeing to voluntarily share information upon request. Though styled as voluntary, likely to skirt anti-privacy related charges, the law contemplates that financial institutions will supply information when asked. Section 314(a) of the Patriot Act requires the Secretary of the Treasury to adopt regulations to encourage law enforcement to share information with financial institutions about suspected cases of AML and in turn for FinCen to promulgate rules requiring institutions to search their records to identify if they have any responsive information with regard to the subject under investigation. In turn, the law provides safe harbors for the financial institution in respect of sharing this otherwise confidential information. Section 314(b) of the Patriot Act mirrors this approach between institutions—it allows two or more financial institutions to share information between themselves regarding customers or transactions suspected of AML without risk of liability.

Banks are also legally responsible for ensuring that the U.S. sanctions regime is not undermined by the inadvertent provision of payments to sanctioned parties or nations. The International Emergency Economic Powers Act (“IEEPA”) empowers the President to impose sanctions on foreign governments and the Secretary of the Treasury helps to enforce these orders through the Office of Foreign Assets Control, or “OFAC.” OFAC maintains a list of specially designated nationals, the SDR list; U.S. banks may not provide financial services of any kind to anyone on this list. OFAC also ensures that financial institutions are not providing services in contravention of any territory-based or sectoral sanctions. FinCen has similar authority to impose blocking measures pursuant to so-called geographic targeting orders authorized under section 311 of the Patriot Act. Pursuant to these orders, a bank is prohibited from providing correspondent accounts directly or indirectly to a financial institution or country that is considered to pose a high threat.

Compliance with the AML and sanctions regimes is extremely complicated for an internationally active financial institution providing correspondent banking services. Most of these institutions are bank holding companies organized as a group. At the group, the c-suite managers and board must ensure AML and sanctions assessments are properly carried out at each of the subsidiaries of the group; and often, whether information from subsidiaries is missing or incomplete may be difficult to know. Correspondent banks often have great difficulty obtaining fulsome information about a respondent bank’s customers and the range of their transactions.

Complicating matters further for internationally active correspondent banks, each jurisdiction has varied approaches to and regulatory regimes for AML. National standards differ and banks must ensure they remain compliant with the rules in each jurisdiction in which they offer services. In the case of cross-border payments in

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<sup>10</sup> BANK FOR INT’L SETTLEMENTS, GUIDELINES SOUND MANAGEMENT OF RISKS RELATED TO MONEY LAUNDERING AND FINANCING OF TERRORISM 30 (2020).

particular, these multiple checks slow down the process and gives rise to fees. As a result of this state-of-affairs, there is considerable redundancy in AML compliance—one party may not rely on the checks of the other under existing U.S. law and international best practice, giving rise to duplicative KYC checks and overlapping monitoring of in-process payment transactions.

Meanwhile, for firms, the cost of error is high given the degree to which U.S. law enforcement authorities have approached enforcement of AML lapses in correspondent banking contexts. Since the high-profile enforcement action and fine against Riggs Bank in 2005—for the failure to properly know its customers—money laundering scandals have plagued the banking industry. In 2018, Danske Bank was discovered to have inadvertently laundered large amounts of illicit funds, a scandal that ensnared J.P. Morgan, Bank of America, and Deutsche Bank—all of which had served to some degree as correspondent banks for Danske Bank Estonia who had in turn used that relationship to access Fedwire to make laundering transfers of U.S. dollars between 2007 and 2015.<sup>11</sup> Only recently in April 2022, law enforcement uncovered the fact that Viktor Vekselberg, a sanctioned Russian oligarch, used shell companies that hid his identity via beneficial ownership to conduct U.S. dollar transactions involving the purchase of a yacht. An affidavit provided by law enforcement stated that Vekselberg used U.S. bank’s correspondent banking services to transfer the funds from abroad as part of his concealment scheme through the shell companies.<sup>12</sup>

The legal and reputational risk of these scandals—and the mere prospect of them—is extraordinarily high for internationally active correspondent banks. As respondents to the FATF’s recent survey of firms in 173 jurisdictions reported, the tight belt-and-suspenders approach to AML, combined with a zero-tolerance policy in enforcement, has generally led to a culture of over-compliance among correspondent banks. In this vein, a June 2021 statement from the Wolfsberg Group on “Demonstrating Effectiveness” explained that “[l]argely in response to supervisory expectations, AML/CFT risk assessments are focused on technical compliance requirements rather than the effectiveness of the [financial institutions’] efforts to prevent and detect financial crime.”<sup>13</sup> As a result, the existing AML regime is extremely costly to comply with. The same respondents in the FATF survey reported an average cost of financial crime compliance of nearly \$50 billion for the 115 mid-size and large firms surveyed.

And in fact, these banks reported that the cost of complying with AML is the *biggest impediment* to conducting cross-border payments. The costs and potential downside reputational risk explain why banks are retreating from correspondent banking, a trend documented by the BCBS, the FATF, and other groups since the global financial crisis of 2008. The Bank for International Settlements (“BIS”) noted a 20% reduction between 2011

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<sup>11</sup> See Olaf Storbeck, *German Authorities Raid Deutsche Bank in Money Laundering Investigation*, FIN. TIMES (Apr. 29, 2022), <https://www.ft.com/content/9fd8a476-d023-4cc7-9598-32b3b4654162>

<sup>12</sup> See Order, *In the Matter of the Seizure and Search of the Motor Yacht Tango*, No. 220SZ-5, U.S. Dist. Ct. for the D.C. Cir., filed Apr. 4, 2022.

<sup>13</sup> WOLFSBERG GRP., *DEMONSTRATING EFFECTIVENESS 1-2* (2021), [https://www.wolfsberg-principles.com/sites/default/files/wb/Wolfsberg%20Group\\_Demonstrating\\_%20Effectiveness\\_JUN21.pdf](https://www.wolfsberg-principles.com/sites/default/files/wb/Wolfsberg%20Group_Demonstrating_%20Effectiveness_JUN21.pdf).

and 2018, based on the volume and frequency of Swift messages between banks; this Swift data also showed that the number of corridors between countries had fallen.

This is a socially and strategically suboptimal outcome. Consider the incentives for banks to engage in “de-risking” — a decision on the part of a correspondent bank to pull up stakes (to terminate or restrict correspondent relationships) in certain geographies that are determined to pose a potentially high risk of AML entanglement. Today, even the prospect of geopolitical uncertainty, and a potential for ensuing economic sanctions, could prompt a bank to retreat anticipatorily. De-risking may well make sense to the bank from a cost-benefit perspective, but it leaves certain populations with little or no access to cross-border payments services. It thus creates space for other nonbank payment systems to take root, which systems might be more open to facilitating illicit finance and to dealing with U.S.-sanctioned parties.<sup>14</sup> On the whole, the current regime appears as expensive as it is ineffective and does not serve international interests in financial stability or economic security.

Still, the solution cannot be to downgrade the intensity of AML rules. From a national security perspective, the heavy-handed approach to AML is prudent and in line with FATF best practice. Efficiency of the regimes is secondary to whether they are as comprehensive as possible. As such, until now, AML policy has to some extent been zero-sum vis-à-vis cross-border payments policy—trimming AML might make correspondent banking more efficient (and thus faster and less costly) but it would clearly work at cross-purposes with the goal of combatting illicit finance.

The next Part explores a way to move away from the zero-sum policy game. It puts the cross-border payment dialogue, ongoing at the FSB, in dialogue with the AML reform agenda. To that end, Part II sketches out a proposed strategy for operationalizing the FSB roadmap in the United States. It urges regulation and law that enables—even incentivizes—the formation of a financial institution (or business line in an existing institution) that centrally clears KYC.

## II. TOWARD A CENTRAL VERIFYING PARTY: INSTITUTIONAL DESIGN AND MARKET STRUCTURE

The U.S. could provide significant tailwinds to the FSB’s cross-border payments action plan by creating a legal and regulatory environment conducive to the centralized ‘clearing’ — that is, verification — for AML-related customer due diligence. The verifying institution would be private in structure and governance, but subject to public oversight and legislative imprimatur in the BSA. This Part outlines the institutional details and market structure surrounding centralized verification of AML/KYC, and suggests what

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<sup>14</sup> According to the 2021 Basel AML Index, 2021 trends indicate significant rise in ML threats from fintech and DeFi. They estimate that there are presently about 106 million cryptocurrency users globally and of the \$21.4 billion value, criminal activity represented about 2.1 percent (\$450 million). BASEL INST. ON GOVERNANCE, BASEL AML INDEX 2021: 10TH PUBLIC EDITION: RANKING MONEY LAUNDERING AND TERRORIST FINANCING RISKS AROUND THE WORLD 7 (2021), [https://baselgovernance.org/sites/default/files/2021-09/Basel\\_AML\\_Index\\_2021\\_10th%20Edition.pdf](https://baselgovernance.org/sites/default/files/2021-09/Basel_AML_Index_2021_10th%20Edition.pdf).

the regulatory framework might involve. It explains why we could expect significant gains in efficiency, risk management, and transparency in cross-border payments from the introduction of a CVP as a new type of payments system infrastructure.

### **A. Institutional Details**

The proposal here is to move toward a system of central verifying parties, or CVPs. In its basic outline, the idea is straightforward—a financial institution that performs due diligence on prospective U.S. bank customers, thereby centralizing the process of KYC. The CVP would also perform the KYC on respondent banks and their downstream customers if and as necessary. In terms of the rigor of due diligence, that standard would be maintained at current, if not higher levels, mapping on to international best practices and current supervisory expectations for individual bank and bank holding companies. Upon completing satisfactory due diligence, the CVP verifies the party with a blue check that can serve as their AML clearance—a passport stamp that correspondent banks (or any banks) can rely on to supply services consistent with BSA and U.S. sanctions related rules.

The CVP function would be analogous to the kind of centralized clearing that is now common to the infrastructure of other financial markets. In both the market for foreign exchange and tri-party repo, shifts from bilateralism to centralization decreased risk and increased transparency, and generally improved operational efficiency. Clear CLS Bank is one such shining-star example. When foreign exchange markets developed in the 1970s (after the fall of the Bretton Woods fixed rate regime), foreign exchange transactions largely cleared bilaterally. This system (much like the OTC derivatives markets that would emerge later) was rife with counterparty risk. One bank failure could impact many others, creating a significant source of financial stability risk. While regulatory reforms aimed to mitigate exposure and operational risk, it was ultimately the formation of the CLS Bank, launched in 2002, that succeeded in reducing risk and increasing operational efficiency.

CLS Bank clears forex via a so-called payment versus payment model. Only when both legs of a transaction are sent to CLS, will CLS make an irrevocable payment to each party. And because in practice, CLS also commits to standby lines of credit with major banks in the currencies that it settles, if one bank fails in the midst of a transaction CLS is still able to perform the transaction. The practice of bilateral netting that CLS performs provides further efficiency gains in the market; by CLS estimates, netting efficiency is around 95%—so for every trillion dollars of gross value settled, only \$50 billion of cash is required to be paid in.<sup>15</sup> The market clearly sees value in the central clearing CLS offers.

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<sup>15</sup> Richard Levich, *Why Foreign Exchange Transactions did not Freeze Up During the Global Financial Crisis: The Role of the CLS Bank*, VOXEU (July 10, 2009), <https://voxeu.org/article/clearinghouse-saved-foreign-exchange-trading-crisis>.

Its average trading volumes in January 2022 were \$1.87 trillion--it clears about 95% of the forex transactions for its 70+ member banks.<sup>16</sup>

CLS Bank also impresses from a stability perspective. It proved remarkably resilient in the 2008 global financial crisis. As one commentator described it, at the peak of the crisis, “the CLS Bank handled more than 1.5 million instructions and settled transactions with a gross value of \$8.6 trillion. In other words, near the peak of the freeze in interbank lending, the CLS Bank was handling a record volume of FX trades for thousands of counterparties.”<sup>17</sup> Essentially, the presence of a central clearing party avoided the kind of credit freeze that plagued other financial markets during that time. This kind of stability is also important from a financial institution cost perspective, as it suggests less need to over-capitalize positions and generally reduces inefficient counterparty risk aversion. (It bears mention that ICE Clear is an almost identical piece of market infrastructure that centrally clears a range of derivative products.)

Innovations in centralized clearing also brought efficiency gains to the repo market. In a repo transaction, collateral (a security) is pledged for cash—in effect, repo is a way for holders of securities to get cash and for cash holders to invest their cash for a return. A “haircut” reflects something like an interest rate on the cash on loan, such that when the transaction is unwound the cash provider has made some profit on the difference between the cash and the value of the collateral. The repo market generally is one of the largest short-term funding markets globally; its volume creates the necessary liquidity and price transparency for U.S. government debt (Treasury securities) and corporate debt.

Tri-party repo is a kind of repo in which a third party—a clearing bank, usually, BNY Mellon—provides intermediation services to the cash investor and the collateral provider. In this role the clearing bank takes custody of the securities collateralizing the transaction, values the securities, then settles the transaction on their books. They may also help dealers make optimal use of their securities, i.e., reinvesting them or rehypothecating them to hedge fund investors that may use them for short sales. Overall, BNY Mellon’s role in taking custody of the securities (so that the parties do not have to) and dealing with the clearing and settling greatly reduces legal and economic risk for the participants and thus encourages many parties to participate in the tri-party repo market. According to researchers at the New York Fed, “the efficiency of the tri-party repo market, and the fact that so many institutions use it, are among the reasons the Federal Reserve uses this instrument to implement monetary policy.”<sup>18</sup>

Arguably, very similar efficiency gains would accompany centralized “clearing” of bank customers and respondent banks—reductions in legal risk associated with cross-border payments and accidental errors in KYC, as well as reductions in economic risk assuming that one centralized party would over time become more adept at customer due

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<sup>16</sup> Keith Tippell, *CLS FX Trading Activity—January 2022*, CLS, <https://www.cls-group.com/news/cls-fx-trading-activity-january-2022/> (last visited May 31, 2022).

<sup>17</sup> Levich, *supra* note 15.

<sup>18</sup> Adam Copeland et al., *The Tri-Party Repo Market before the 2010 Reforms*, Fed. Rsrv. Bank of N.Y. Staff Reports, Nov. 2010, at 4, [https://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr477.pdf](https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr477.pdf).

diligence and monitoring than would individual financial institutions acting on an ad hoc basis. Further, to the extent centralizing KYC would also lead to more streamlined, accurate, holistic due diligence, general transparency in the cross-border payments market could also be expected.

For some, this suggestion for a CVP begs the question whether a private institution— analogous to CLS Bank or BNY Mellon—is better suited to the task of performing centralized verification than a public body, like FinCen or the Fed. There are at least two compelling reasons, grounded in their respective incentives and institutional designs, to prefer a private institution to a public body for his purpose.

For one, it is not clear the public sector has the resources or the political will to perform this central verifying task. The most recent effort at reform, the AML reform bill enacted in 2020 (effective in January 2021), requires that Treasury and FinCen provide more transparency into their supervision priorities and attempts to ease the KYC burden on firms by positioning FinCen to create a national registry of beneficial ownership.

But both the registry and new procedural rules have been slow in coming. These reforms did not accomplish the mission-critical task of reducing redundancy among the correspondent banking institutions' KYC compliance—probably because the government lacks the resources to supply this service to the banking sector and, in any case, doing so may be perceived to insert the government too deeply into matters of customer privacy and banks' discretion about whom to serve. Relatedly, there is far less risk that a private institution would be susceptible to political capture and the temptation to make diligence decisions for reasons not necessarily related to national security concerns but more so to political preferences or antipathies of a given day.

A final element of a CVP design concerns incentives. Under what conditions would a CVP form organically, without a regulatory mandate? Again, the experience of CLS Bank, BNY Mellon's tri-party repo business, and ICE Clear, all suggest there is a natural market demand for centralizing clearing-type services where there are efficiency and risk mitigation gains to be had. The participating financial institutions (i.e., the members) would also need strong incentives to use the CVP system. Ideally, most if not all financial institutions participating in the correspondent banking network would use the blue check system in order to achieve maximum efficiency gains from a CVP infrastructure.

This means that the institutions would need to trust the CVP's services sufficiently to rely on its due diligence and not replicate their own. In principle, a private institution that is member-owned and governed could develop and maintain a governance structure capable of attracting that kind of intra-market trust. CLS Bank is member-owned as is ICE Clear U.S. In fact, ICE Clear refers to its strict membership criteria (including robust capitalization, sterling regulatory compliance, among other things) as one of the principal reasons its clearing services hedge systemic risk for its members.

Ultimately, however, given the very significant legal and reputational cost of erring in a KYC determination, financial institutions would have to be legally assured that their reliance on a CVP determination could not lead to liability. The most direct route to such assurance is a safe harbor legislated into the BSA. Section 326 already provides that the

minimum requirements for KYC are set by regulation promulgated by the Treasury; section 326(5) allows exemptions made by the Secretary of the Treasury for any reason. So conceivably, even absent legislation, the Treasury Secretary could issue new regulations, interpretive guidance, or no action letters to a similar, albeit perhaps less permanent effect than a statutory safe harbor.

International standards and their implementation through oversight would also need adjusting. Currently, FATF recommendation 17 discourages reliance on third parties for customer due diligence—it notes that “ultimate responsibility remains with the financial institution relying on the third party.” So long as that remains the regulatory stance, it is highly improbable that market demand for a CVP would be sufficient to incentivize any such institution to form for the purpose of performing centralized verification services.

While this section has urged a design that envisions the CVP as a private institution—and one that could develop organically in response to market demand, and without a statutory mandate—the next section will explore how oversight from the public sector would be a key component of any new CVP market infrastructure.

## **B. Market Structure and Regulatory Framework**

The ideal market for CVP infrastructure likely consists of one institution. It seems sub-optimal to have more than one party conducting due diligence—potentially producing conflicting records. And unlike the case with, for instance, the pre-2009 tri-party repo market where both JP Morgan Chase and BNY Mellon provided clearing services, there is no benefit to diffusing clearing exposure in the way that one might consider in the repo market—there is no risk of concentrating KYC analysis. Information sharing with law enforcement would also be much more streamlined from one CVP institution. Moreover, there are information-security downsides to sharing customer data with more than one institution.

It is noteworthy that clearing has settled around one major market infrastructure in the other financial markets discussed—CLS Clear for forex and BNY Mellon for tri-party repo (indeed, JP Morgan left the market because its 15% or so market share was paltry compared to BNY Mellon’s 85%+). Similar concentration exists in the over-the-counter derivatives market—LCH Clearnet handles around 95% of derivatives clearing and ICE clears about 98% of global credit default swaps.

The public sector role is also key to a successful CVP design, as it would be important to include CVPs within the regulatory perimeter. Given the concentration of private information in a CVP, the risk of operational risk related events—like a cyber theft of personal data—would be high. Additionally, just as KYC programs are the subject of supervision presently, within banks, so too should the process and governance of the CVP’s central KYC. Although CLS Bank and ICE Clear initially formed outside the regulatory perimeter, both were eventually brought into the Fed’s supervisory perimeter



on the basis of a designation as a “financial market utility” (“FMU”) by the Financial Stability Oversight Council (“FSOC”).<sup>19</sup>

Section 804 of the Dodd-Frank Act empowered the FSOC to designate clearing houses as systemically important pieces of market infrastructure, hence ICE Clear Credit (formerly ICE Trust) and CLS Bank are now FMUs. Unlike the FSOC’s designations of systemically important nonbanks, the FMU designation has never been controversial or contested by the institutions themselves. Were the CVP to become a new business line within an existing systemically important bank—just as BNY Mellon performs tri-party repo clearing—then this component of the bank’s business model would be subject to the Fed’s heightened supervision pursuant to its status as a U.S. G-SIB. Again, the key components of the supervisory regime for a CVP would focus on cyber risk (the risk of data loss), the rigor of the KYC diligence procedures (compliance with FinCen rules and pace with FATF best practices), and customer privacy protections.

In terms of the location of the CVP, the institution could be U.S. located, operated, and supervised but broadly serve the international community’s goals in improving the efficiency of cross-border payments. For decades, the international community has attempted to harmonize AML rules by standard setting among networks of financial crime intelligence units (like FATF) or central banks (BIS, BCBS, FSB). The private sector has tried similar voluntary private governance arrangements through organizations like the Wolfsberg Group, a group of thirteen global banks that develop frameworks and guidance for the management of AML risks and KYC best practices. Notwithstanding these concerted efforts, standards are not harmonized and there is little if any substituted compliance by which one jurisdiction will credit a firm’s compliance with another’s AML scheme.

Introducing a CVP as a new kind of payments infrastructure has promise for quieting this cacophony of global standards. Although the CVP would at least initially verify parties against U.S. standards (BSA, FinCen rules, OFAC SDR list, etc), the efficiency that it offers could create the incentives needed to drive global convergence around U.S. (and hence international best practice) AML standards. If a U.S. CVP offers the blue check for domestic AML rules, the service will act like a centrifugal force. Given its convenience, banks in other jurisdictions will want to service customers with the blue check to avoid undertaking the work at their own expense.

These foreign banks will thus have strong incentives to pressure their home governments to adopt U.S.-mirror standards which, in turn, the CVP might recognize as substituted compliance and award the blue check. An example helps to illustrate. If French citizen Jane Smith has a CVP blue check, and wants to borrow from Société Générale, over time, SocGen will want the French authorities to adopt a regime sufficiently similar to the U.S. so that the U.S. CVP is willing to offer blue checks that satisfy French rules as well. Customers like Jane Smith will press for this as well so that

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<sup>19</sup> The CFTC is the primary supervisor of ICE Clear; but the Fed has additional supervision of ICE Clear from a financial stability perspective thanks to powers granted to the Fed in Title VIII of the Dodd-Frank Act.

their blue checks gain them entry to both U.S. and French banking services. These incentives and dynamics may well generate a private market mechanism that functions as if all jurisdictions had agreed to harmonization or substituted compliance—which, in the absence of such private sector initiatives—currently seems unlikely to materialize from multilateral efforts.

In time, if the CVP were sufficiently global in its reach, the Fed might explore a cooperative oversight arrangement similar to that which applies to CLS bank. Pursuant to a “Protocol for the Cooperative Oversight Arrangement of CLS,” the central banks of issues that CLS settles are able to “fulfill their responsibilities to promote safety, efficiency, and stability in the local markets and payment systems in which CLS participates,” while also ensuring that the cooperative mechanism minimizes potential burden on CLS and duplication of effort by the participating central banks” and maximizes transparency among the central banks and between CLS and these supervisory authorities.<sup>20</sup>

In summary, a new payments infrastructure that provides centralized verification for KYC or CDD purposes, that is privately owned and operated but subject to Fed oversight, has significant potential—both in theory and in reference to close institutional and market precedent—to enhance the efficiency and reduce the risks in correspondent banking. These gains should directly translate into a better experience for the users and service providers of the cross-border payments system. For these reasons, as discussed above, the U.S. should consider prioritizing legal and regulatory reform that would create the space for the private market to form a CVP. Such reforms would be consistent with, and substantially further, the overarching goal of the G20 and FSB to take action to lower the cost and increase the speed, transparency, and ease of access of cross-border payments systems.

Taking a step back, this proposal for infrastructure reform in the cross-border payments space also carries implications for adjacent policy conversations surrounding nonbank alternatives to cross-border payments.

### III. IMPLICATIONS FOR NONBANK PAYMENT ALTERNATIVES

While most of the FSB workstream centers on efficiency problems with cross-border payments—with an eye to the end-user’s experience—there is a parallel debate in central banking policy circles about whether nonbank alternatives to cross-border payments should be encouraged to supplant or supplement legacy correspondent banking systems. The proposal advanced here contributes something to that debate as well, insofar as it questions the benefits of these nonbank alternatives relative to a correspondent banking system that can process cross-border payments more efficiently thanks to new CVP infrastructure. The prospect of a correspondent banking system that can take advantage of this streamlined, potentially more accurate, AML should prompt policymakers to reconsider the cost-benefit analysis of nonbank payments options. The following will

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<sup>20</sup> *Protocol for the Cooperative Oversight Arrangement of CLS*, FED. RSRV. (Sept. 2, 2009), [https://www.federalreserve.gov/paymentsystems/cls\\_about.htm](https://www.federalreserve.gov/paymentsystems/cls_about.htm).

briefly consider two of the primary nonbank payment alternatives—stablecoin and CBDC.

### A. Stablecoin and DeFi

There are several well-known fintech payments providers that are not banks—Wise, PayPal, and ApplePay, to name a few. These companies are regulated at the state level as money service businesses or MSBs. A few MSBs are also entering the cross-border payment space, like Wise, RippleLabs, Banking Circle, and Payoneer. These fintechs are trying to compete with legacy banks and the incumbent correspondent banking system on, again, dimensions of speed and cost. For remittance customers, these fintech MSBs may well be attractive alternatives.<sup>21</sup> And new fintech entrants to the payments space continue to arrive on the scene annually and will no doubt attempt to serve other segments of the market—B2B, B2C, and C2B.

Most of these fintechs are subject to some amount of federal regulation, like consumer protection rules (such as Regulation E which protects consumers from the downside risks of fraud in international wires) and all MSBs are at least in theory subject to AML rules. Still, because of their diffuse character and lack of bank regulatory oversight, it remains unclear whether and to what extent lapses are detected.

Moving even further on the spectrum away from the legacy banking system is decentralized finance alternatives, known as “DeFi.” DeFi protocols essentially aim to replicate the services banks provide—including payments—but by using smart contracts on the blockchain. In the language of DeFi, its protocols offer banking-like services that are “internet native”—cutting out the role of an intermediary and replacing it with a smartphone wallet. The trust established by the banking license and customer-facing relationship is replaced with a kind of information insensitive trust associated with automation and the (supposed) impregnability of DLT technology. The component of DeFi most directly implicated in cross-border payments is cryptocurrency. Cryptocurrencies are forms of payments that each proceed on their very own payment rails, all outside of the banking sector.

Stablecoins are perhaps the most likely of the cryptocurrencies to have potential for widespread adoption by consumers and businesses. Stablecoins have a value that is pegged to a fiat currency—like the U.S. dollar—similar to the way that a money market fund pegs the value of each share to \$1. Also like a money market fund, stablecoin issuers back their coins with a pool of assets, ranging from Treasuries to commercial paper. Presently, however, because stablecoins sit entirely outside of a regulatory perimeter there are no rules or mechanisms of oversight regarding the liquidity or other characteristics of these asset pools.

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<sup>21</sup> The Federal Reserve Bank of Kansas City has reported, as one piece of anecdotal evidence, that many in the Latino population in its district may withdraw money from their banks yet use MSB to remit money, regardless of their documentation status.

Stablecoins are gaining policymakers' attention. Both the Treasury and the Fed—and their counterparts in Europe and the U.K.—seem tentatively supportive of the proliferation of stablecoin as a mechanism for improving the efficiency of cross-border payments. In the seemingly shared view of the Fed and Treasury, a “well-designed and *appropriately regulated* stablecoin could potentially support faster, more efficient, and more inclusive payment options.”<sup>22</sup> The rise of stablecoin and fintech more generally begs a critical question for U.S. policy on cross-border payments: should policy and regulation encourage a diffusion in payments systems either proactively or by inaction—as we are currently on track to do—or should U.S. policymakers make concerted efforts to bolster the correspondent banking system by drawing innovative fintech payment technology *into* the correspondent banking framework?

At the baseline, correspondent banking offers several key strategic advantages to stablecoins. For one, the banks participating in correspondent banking relationships are already within the Fed's regulatory perimeter. In the U.S. that means that bank supervisors at the OCC and Fed have sight into the banks' risk-management practices and balance sheets, and find the banks willing partners in a range of monetary and strategic initiatives where needed. As such, in times of economic or political crisis, public-private partnerships are readily available. Liquidity can flow between governments or between consumers in a targeted fashion.

Likewise, with payments activity consolidated in the banking sector and running through Swift, governments can choke off access to the dollar (and Euro) as a means of non-armed economic warfare. This, of course, is how the U.S. and its allies successfully isolated the Russian economy in the spring of 2022 in response to its unprovoked invasion of Ukraine. If payments systems had been more diffuse, among institutions with no interest in or incentive to partner with government in such times, the United States would have had no other equally impactful, but not overtly forceful, option to use against Russia.<sup>23</sup>

Correspondent banking is also—right now—much more stable than stablecoins. In early May 2022, stablecoins proved they could be highly *unstable*, when one of the most prominent stablecoins, TerraUSD, failed to maintain its \$1 peg (dropping as low as 23 cents at one point in that volatile week). TerraUSD, like other stablecoins, is integrated into the crypto universe's parallel financial ecosystem; when TerraUSD investors began to withdraw their coins from Anchor, a DeFi 'bank'-like protocol, the value of TerraUSD plunged and its algorithm was unable to maintain the dollar peg as envisioned by its designers. Cyber risk—a known source of possible financial instability—is also likely to be amplified by a diffusion of payments systems away from the established banking sector

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<sup>22</sup> Press Release, U.S. Dep't of the Treasury, Fact Sheet: President's Working Group on Financial Markets (PWG), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (Nov. 1, 2021), <https://home.treasury.gov/news/press-releases/jy0456>.

<sup>23</sup> Recognizing the importance of payments infrastructure to national survival, Russia has apparently for some time been developing its own payment network, National Payment Card System or NSPK. This has apparently allowed the Russian economy to continue processing domestic payments, but without access to Swift, it forces Russia into an unsustainable position of autarky.

and across myriad stablecoin issuers. A wider array of platforms, technologies, systems and protocols creates many more nodes of opportunity for cyber attackers to target the payments infrastructure, which, in turn, increases the likelihood of a panic-inducing event that can then create contagious spillover effects when people instinctively react to bad economic news.

And perhaps most importantly, correspondent banking is a more practical avenue for improving cross-border payments in the near-term. Unlike correspondent banks, the DeFi ecosystem has not yet solved the interoperability problem in a way consistent with the global rule of law. Even assuming coins could be sent from a wallet in Country A to a wallet in Country B, those coins could not be used to directly purchase everyday needed items or to satisfy tax obligations. Jurisdictions where this becomes possible may be willing to allow the free use of stablecoin directly in the economy, but without accompanying AML checks.

While policy need not be designed to stifle stablecoin innovation, it should consider how stablecoins might best fit into the existing model of banking and, in respect of cross-border payments, into the correspondent banking model specifically. This suggests bank policy that allows banks to explore innovations in payments instruments like tokenized deposits, which authorizes bank partnerships with crypto activities, and possibly makes more use of special purpose bank licenses for stablecoin paired with direct access to an account at a Federal Reserve Bank.

Cross-border payments is just as much a question of geopolitical and national security as it is one of efficiency. Balancing these goals suggests a U.S. interest in precluding the entrenchment of nonbank payments systems and accompanying infrastructure that may well undermine the dollar and the international community's goals of stemming the flow of illicit payments.

## **B. CBDC**

Concern for the potential erosion of monetary and payments system sovereignty is also the Fed's stated rationale, like other central banks, for exploring a central bank digital currency. A CBDC would introduce a new form of money into the economy, which is a distinct liability of the central bank. In broad strokes, CBDC would be a new kind of central bank money (i.e., reserve) that is available to retail consumers, not only financial institutions. A CBDC would exist alongside cash as another medium of exchange—in theory, CBDC can be used by retail customers to execute cross-border payment transactions (though given interoperability challenges, the details of how that would work in practice, however, remain murky).

As in the case of stablecoin, the case for a CBDC is weakened if privately issued bank deposits can be more efficiently transferred across borders for transnational payments. In other words, CVP infrastructure could make CBDC superfluous to the cross-border payments problem. And holding fast to the status quo system of privately issued bank deposits, which coexist alongside central bank money, would continue to keep monetary

sovereignty intact. A best-in-class correspondent banking system, anchored around a CVP, would also strengthen the infrastructure of the dollar generally, assuaging concerns about the dollar's status vis-à-vis competing currencies (another stated rationale for a CBDC). Financial inclusion is also cited as a key benefit to CBDC. While it remains unclear how a CBDC could serve this goal, it is clear that de-risking works at cross-purposes to financial inclusion as does allowing shadow markets for remittances to exist outside the regulatory perimeter, where consumer abuses can more readily take place.

Overall, then, centralizing KYC with a new CVP payments infrastructure seems likely to achieve the benefits sought from a CBDC (i.e., better payments, monetary sovereignty, dollar dominance, and financial inclusion) while avoiding the anticipated costs of introducing a CBDC. Those costs include, for example, privacy concerns with a state-issued digital currency. Those concerns are muted when a private institution as opposed to the government processes one's payments digitally. Additionally, CBDC—and the possibility of programmable money—gives rise to the specter of social control. That too is avoided with privately issued currency and privately processed payments transactions. CBDC also threatens disintermediation of the banking sector; meanwhile, the proposal offered here doubles down on an intermediated approach to cross-border payments—avoiding the possibility of destabilizing flights to dollar quality. To the contrary, a CVP could very well act as a stabilizing force in the market for cross-border payments during the next global economic crisis, just as CLS Bank did in 2008.

In sum, addressing the core problems with correspondent banking—fragmented and redundant KYC—is a much more judicious way of addressing the current imperative to maintain an efficient, inclusive, and transparent payments system than would the development of a CBDC.

## CONCLUSION

This paper has used the FSB workplan for cross-border payments as a launchpad for considering how the U.S. can best move this international initiative forward. While the FSB has urged 19 areas for multilateral attention, this paper suggests that U.S. financial policy should prioritize the fragmentation and redundancy of AML, and the KYC diligence process in particular. To enhance the overall efficiency of cross-border payments, the paper suggests infrastructure reform in the payments market in the form of a central verifying party, CVP, that would centrally “clear” customers (respondents and their downstream affiliates) of U.S. banks. The design of the CVP suggests there would be significant market demand for such infrastructure, provided it was legally sanctioned in the BSA and supervised for operational and privacy related risks as an FMU.

Ultimately, the ability to improve the efficiency of cross-border payments within the legacy correspondent banking system suggests the benefits of nonbank payment alternatives are relatively lower than their costs—namely, the costs associated with stablecoins outside the bank perimeter and those anticipated from the introduction of a CBDC.

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