SEACEN FINANCIAL STABILITY JOURNAL

Insights and Thought Leadership on Financial Stability

Shadow Banking and Financial Stability
Jean-Pierre Landau

Shadow Banking, Financial Technology (FinTech), and Financial Inclusion – Three Pathways of Rapid Change in the Financial Services Industry
Summarized by Glenn Tasky

The New Zealand Experience with Macro-Prudential Policy
Grant Spencer

Consolidated Supervision and Anti-Money Laundering Compliance: The Crossroads of Effective Banking Supervision
Gary Gegenheimer
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## Article Submission Guidelines

The *SEacen Financial Stability Journal* Editorial Board welcomes potential contributions to the *Journal*. Articles written for the *SEacen Financial Stability Journal* should focus on providing insights and thought leadership with respect to information and developments relevant and critical to promoting financial stability and related matters, contextualized to the Asia-Pacific region.

- Article drafts should be submitted in 12 point Times Roman font and should be double-spaced, and sent by email to: article@seacen.org.
- The length of draft articles will generally range from 3,000 to 5,000 words (12 to 20 double-spaced typed pages), though treatment of some topics could necessitate longer articles, which would be considered.
- Authors should include a biographical summary at the end of the article. If an article expresses expert opinions, contributors’ expert credentials should be apparent.
- Articles will be evaluated by the *Journal’s* Editorial Board.
- We are available at any time to answer authors’ questions, discuss potential articles, review early drafts, or provide other input. Please contact:

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### Editorial Board

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<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
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</tr>
</thead>
<tbody>
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<td></td>
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<td></td>
<td>Financial Stability and Supervision</td>
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<tr>
<td></td>
<td></td>
<td>The SEacen Centre</td>
</tr>
<tr>
<td>Glenn Tasky</td>
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<tr>
<td></td>
<td>Director, Financial Stability and Supervision</td>
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</tr>
<tr>
<td></td>
<td></td>
<td>The SEacen Centre</td>
</tr>
</tbody>
</table>

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Contents

Letter from the Executive Director ... iii

Shadow Banking and Financial Stability
By Jean-Pierre Landau ... 1

Shadow Banking, Financial Technology (FinTech), and
Financial Inclusion – Three Pathways of Rapid Change
in the Financial Services Industry
Summarized by Glenn Tasky ... 15

The New Zealand Experience with Macro-Prudential Policy
By Grant Spencer ... 29

Consolidated Supervision and Anti-Money Laundering
Compliance: The Crossroads of Effective Banking Supervision
By Gary Gegenheimer ... 41
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Letter from the Executive Director

Dear Colleagues and Readers

The first issue of the Journal for 2019 reflects the rapid changes taking place in the financial services industry that require cutting-edge thought and analysis as well as practical solutions to the many challenges remaining for the industry a decade after the Great Financial Crisis (GFC).

The lead article, by respected French academic and central banker Jean-Pierre Landau, traces the rise of shadow banking to the fundamental and immutable urges that drive all financial markets: suppliers of funds want instant access to their money, while users of funds need the money predictably and uninterruptedly for long periods of time. The mutual satisfaction of these conflicting wants and needs is done through maturity transformation – which will be done through banks if permitted, and through shadow banks if banks are constrained.

Next, Chief Editor Glenn Tasky takes the reader through several sessions of a SEACEN high-level seminar and Policy Summit, focusing again on shadow banking but also covering financial technology (FinTech) and financial inclusion. All three aspects of financial services are undergoing profound change, as the industry recovers from the GFC, takes advantage of rapid improvements in information technology and communications, and reaches out to communities that are not well served by formal financial institutions. All of these changes are taking place against a backdrop of increasing consumer demands and deteriorating public trust, with misconduct by bankers a repeated and unwanted occurrence.

Former Reserve Bank of New Zealand (RBNZ) Governor Grant Spencer then looks at the recent financial stability landscape in New Zealand, and the efforts of the RBNZ to address potential risks such as the sharp rise in house prices with macroprudential policies. He concludes with three lessons for policymakers in other countries to boost the success of their macroprudential measures.

Finally, international banking law consultant and former U.S. regulator Gary Gegenheimer adds an AML/CFT perspective to the broad issue of consolidated supervision – when the banking supervisor examines and monitors banks that are part of a larger corporate group, which could include other financial institutions and even non-financial companies. He argues that loose money laundering / terrorist financing controls at other entities within a corporate group that includes a bank can damage the reputation of the bank, and makes the case that the banking supervisor should have the right to request information from these other entities on their AML/ CFT regimes, and take that into account when making judgments about the ability of the parent or other affiliated entities to act as a source of strength for the bank.
I would like to express my sincere gratitude to our readers, authors, SEACEN member central banks and monetary authorities, and the Journal’s Editorial Board for their contributions toward its success to date, and for their continued support. For this issue, a special word of thanks to Herman Saheruddin, Research Specialist, Research Group, Indonesia Deposit Insurance Corporation; and to Atty. Enrique C. Domingo, Executive Director II, ODG Resource Management Sector, Bangko Sentral ng Pilipinas.

Dr. Hans Genberg
Executive Director
January 2019
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Shadow Banking and Financial Stability

By Jean-Pierre Landau

The regulatory reforms undertaken after the Great Financial Crisis of 2008 – 2009 have yielded impressive results. Capital and liquidity buffers have been rebuilt and increased in the most critical parts of the world banking system. Those reforms have significantly reduced financial fragility, strengthened the robustness and resilience of global financial institutions and protected taxpayers against the consequences of possible bank failures in the future.

Yet, regulators and Central Bankers cannot rest assured that all dangers have been eliminated. Shadow banking, in particular, has emerged as a major source of debates and concerns for financial stability. This article presents a description of “shadow banking” activities and discusses the challenges they pose for regulators.

1. Different Forms of Shadow Banking

According to the Financial Stability Board (2017) shadow banking can be defined as “credit intermediation involving entities and activities (fully or partially) outside the regular banking system”. That definition encompasses all forms of credit, by all non-bank entities, including asset management companies and Funds that issue and buy debt and money instruments. This article will follow suit and consider mutual and open “funds” that issue redeemable liabilities and invest into long term securities as integral parts of the shadow banking system.

Yet, while very broad and comprehensive, that definition is not fully satisfactory. The reference to “credit” is partially misleading. Shadow banking is more broadly related to financial intermediation. Maturity transformation, not credit, is a defining component. While credit involves leverage, maturity transformation requires liquidity. Most shadow banking entities have little or no capital. The whole system of shadow banking relies upon the permanence and availability of liquidity inside the intermediation chain. The main risks attached to shadow banking come from that structural liquidity mismatch, as well as potential liquidity shortages and freezes. A better definition, although less official, can be found in an ECB working paper (ECB, 2012): “shadow banking refers to activities related to credit intermediation, liquidity and maturity transformation that take place outside the regulated banking system”.

Shadow banking is also very country specific. The same denomination has very different meanings in different parts of the world. To oversimplify, two main categories can be distinguished: “Chinese style” and “western style” shadow banking.
1.1 Shadow Banking in China

In China, shadow banking mainly consists of intermediation activities where banks play a central role as operators but manage to keep the transactions off their own balance sheets – thus avoiding capital, liquidity, and interest rates regulations. This can be done through various means. Two techniques, in particular, have met in China with considerable success and development.

Chinese banks use so called “trust companies”, to organize direct lending between corporates, and “bypassing the banks’ balance sheets, through so called “entrusted loans”. Trust companies are less regulated than banks, although banks are sitting as effective - but not financial – operators.

For the purpose of collecting savings without being subjected to interest rate regulations, Chinese banks issue “bankers’ notes” or sell to households various “wealth management products” (WMPs), whose proceeds are invested into pools of assets, sometimes with high expected returns. Some of those WMPs share many characteristics with the structured investment products and vehicles used by U.S. banks before the 2008 crisis. They offer higher yields than bank deposit rates while being promoted as a low-risk instrument. The graph below illustrates the strong growth of WMPs in China over the last five years and the importance of shadow banking in the Chinese financial system.

Figure 3. China: Wealth Management Products (WMPs) — Balance Outstanding, 2010–2016
(In percent)

Source: Wind Info (2016) and IMF staff calculations.

(Source: IMF FSAP China, p.17)
For all its volume and importance and the risks attached, China's shadow banking remains somehow traditional. The policy response is easy to define and frame, although it may prove politically difficult to implement.

First, supervisors should benefit from full transparency of shadow banking operations so that they can properly measure and assess the risks. They must have the powers to compel the banks, if necessary, to limit or internalize those operations. To the extent that shadow banking effectively prospers in opaque structures, transparency will act as a self-regulating mechanism.

Second, because shadow banking depends on the explicit or implicit capital and liquidity support from its sponsor banks, supervisors may act indirectly through requirements imposed on the banks themselves. This approach was adopted in western economies, to reform securitization and put an end to its excesses after the 2008 crisis.

Finally, strong consumer information and protection as well as regulation of saving products may be necessary to avoid any mis-selling and a subsequent loss of confidence in the financial sector.

Shadow banking in China should not be treated casually. The volumes are significant. The risks are real and must be confronted. From an analytical perspective, at least, the way to stronger regulation and greater financial stability can be well identified. The same does not hold for the “western style” shadow banking.

1.2 Shadow Banking in USA and Europe

“Western type “shadow banking is quite different and more complex. Deposit banks do not play a central role. Major actors are non-bank entities: money market funds, mutual funds, asset management companies and dealer banks. Together, they operate multiple intermediation chains with several layers of maturity and liquidity transformation.

At this stage, it is useful to make a distinction between two types of intermediation: shadow banking in a narrow sense, that designates short term intermediation taking place in debt and money markets; shadow banking in a broader sense involves investment funds and asset managers issuing (almost) immediately redeemable shares and investing the proceeds into long term (debt and equity) securities.
Shadow Banking in a Narrow Sense

The 2008 crisis was mainly propagated and amplified by shadow banking entities which operated on the very short end of financial intermediation, on money and short-term debt markets. The purpose of those markets is to permanently allocate liquidity between financial intermediaries through the exchange of cash vs securitizables. Suppliers of cash are mostly money market funds (MMFs). Ultimate users of cash are so called “institutional cash pools” who manage long term portfolios but need cash to be able to transact on those portfolios. Those are hedge funds, insurers, and pension funds. Shadow banking helps them to temporarily liquefy their part of their portfolio and get the cash necessary to finance their transactions. In the middle, stand a very small number - less than fifteen - of dealer banks, that intermediate between providers and users of liquidity. In the US, investment banks are a both intermediaries and final borrowers on money and short-term debt markets where they fund their long-term portfolios of securitizables.

The engine that keeps shadow banking running is the exchange of securitizables (collateral) for cash through repos (repurchase operations). Repos allow for the circulation of cash in conditions of maximum security as each and every transaction is secured by collateral. The availability of collateral, therefore, is vital for shadow banking to function. Most of collateral consists of Government bonds. A significant part, however, is privately created collateral. This happens through securitization: the bundling and tranching of existing loans, with, as a counterpart, the issuance of short-term debt, such as Asset Backed Securities (ABS) that can serve as collateral.

That intimate link between collateral, repos and securitization, forms the backbone of shadow banking. On the one hand, shadow banking uses collateral in repos between participants: MMFs, cash pools and investment banks; on the other, shadow banking produces collateral through securitization of loans undertaken by investment banks and asset managers. When securitization collapsed in 2008 as a result of its mismanagement and excesses, the whole shadow banking system was paralyzed. The crisis has been aptly described as a “run on repos” (Gorton, Metrick, 2009). As confidence in collateral vanished, repos froze and cash stopped moving. The system progressively recovered, through massive interventions by public authorities, and today it is alive and well. But it never came back to its previous level of activity. The trust in structured securitization had been irreversibly damaged. In addition, regulatory reforms in the banking sector have made it costlier for dealer banks to use their balance sheet and act as intermediaries between other shadow banking entities. As illustrated in the graph below, the volume of outstanding repos in the US has been broadly stable over the last seven years.
Shadow Banking in a Broad Sense

Strikingly, however, at the same time when traditional shadow banking is shrinking in terms of overall volume and importance, another form of non-bank intermediation is growing fast. It takes place in open-ended funds that issue short term – almost immediately redeemable- liabilities and invest into long term (debt and equities) securities. This is the contemporary, modern, form of shadow banking, closely identified with the asset management industry. As compared to the more traditional form, there are two differences: first, it involves a shorter chain of intermediation and maturity transformation: cash brought into funds by savers is directly invested in long term securities and does not change hands multiple times through securitized transactions; and, second, a significant part of investments is made across borders.

This is of great importance for Emerging Economies (EMEs) which today are at the receiving end of shadow banking and directly affected by how it works. For them, problems in advanced countries shadow banking translate into “large and volatile capital flows” according to the accepted terminology. These are two sides of the same reality, depending on whether one looks at it from the origin or destination of capital flows. In the future, EMEs will be major actors on both sides of shadow banking. The conjunction of income growth and high saving rates will produce a sharp rise in the ratio of global wealth to income and increase the demand for asset management services in the emerging world. Chinese asset management sector is expected to top trillions of USD in total assets sometime during the next decade.
This second aspect of shadow banking – akin to market-based finance and asset management – raise specific challenges due to its growing size and systemic importance.

In advanced economies, and, increasingly, in emerging ones, banks are becoming minority actors in financial intermediation. Already, the balance sheets of asset managers are similar in size to those of banks (Haldane, 2014). In aggregate, the top ten banks and asset managers in the world total $20 trillion and $25 trillion in assets respectively. And asset managers grow faster. It is reasonable to expect that, in a not too distant future, asset management will overcome banks as the main channel for financial intermediation.

At the same time, its systemic importance is becoming apparent. Apart from its size, what makes asset management systemic is the conjunction of its imprint on financial markets and the inherent maturity transformation it performs. A significant part of the industry is represented by collective investment vehicles (“funds”) that issue liquid, safe and short-term liabilities and invest into illiquid, risky and long-term securities (or, less frequently, loans). To quote the FSB, (2017) “growth in the asset management sector has been accompanied by increased investment in particular asset classes, including some less actively traded markets, through open-ended funds that offer daily redemptions to their unit holders.”

Figure 3.6: Growth in Bond Funds by Investment Focus
(Assets under management of bond funds worldwide; billions of U.S. dollars)

Sources: Lipper; and IMF staff calculations.

Source: IMF (2015)
Shadow Banking and Financial Stability

From a historical perspective, open-ended funds have not generally created global financial stability concerns or stress. However, there are reasons to carefully consider future risks and vulnerabilities that result from the core function of those funds, i.e., direct and large-scale maturity transformation. The main vulnerabilities come from their exposure to runs, on the one hand and the illiquidity of their assets, on the other.

The risk of run is obvious when, as for MMFs in the US until the recent reform, the net value is (implicitly or explicitly) guaranteed. Then, if some investors start having doubts on the intrinsic value of the fund, they will try to cash in at the guaranteed value before troubles become intractable, thus triggering a run. That those institutions are susceptible to runs has been illustrated in September 2008 when one such run occurred on a major US MMF, the Reserve Primary Fund, forcing the Federal Reserve to create a special facility to support the whole industry.

Most of the Funds, however, provide no guarantee on the redemption value and the investment risk is being put back to end-investors. Many funds or products, however, such as open mutual funds or Exchange Traded Funds (ETFs), are explicitly organized to provide instant or quasi immediate (daily) liquidity. It is generally assumed that since they do not promise any specific redemption value, they are not exposed to runs. This is wrong. For runs to take place, it is sufficient that “first movers” have an advantage over those investors coming later for redemption. Investors can rationally anticipate that, once redemptions have started, the ensuing liquidation of assets will drive down their price, and the value of the remaining shares will drop. First movers will get better value than those coming later.

A second vulnerability comes from the assets into which funds are invested, especially corporate bonds, both in advanced and emerging economies. There is currently an uncertainty on the liquidity of many, if not most, of bond markets. This is of course, crucial as those securities form “the end of the chain” of maturity transformation by the shadow banking system. Large fire sales could occur in response to redemptions from open funds and would trigger wide instability if markets are illiquid, with huge price swings and potential effects on the financial system and the broad economy.

An active debate is taking place on the impact that Basel III regulation has on market liquidity. Most market participants would argue today that Basel III capital and liquidity requirements have a negative effect by increasing the cost, for intermediaries and market makers, of holding inventories of securities in their balance sheets. Indeed, those inventories have dropped significantly over the last few years. In response, regulators point to usual indicators of liquidity, such as bid-ask spreads, that haven’t changed as compared to the pre-Basel III period. Everyone admits, however, that market behavior in times of stress has been puzzling in many
recent episodes. There have been three instances of “flash crash” – ample moves in prices in a few seconds – that have never been fully explained yet. They occurred in the most liquid markets: the bond markets of the largest sovereigns (US and Germany) and foreign exchange (Pound Sterling). It is likely that new methods of algorithmic trading have played a role in those unexpected market dynamics. Those episodes have been very short lived with no consequences. They show, however, that current markets dynamics are unpredictable and difficult to analyze and understand.

Together, the risk of run and asset illiquidity make a very fragile and potentially unstable combination. It is easy to imagine a dynamic where important redemptions and strong corrections in asset prices will fuel each other in a dangerous spiral. Indeed, we’ve seen examples of such dynamics already. The “taper tantrum” that occurred in July 2013 when markets misinterpreted a Federal Reserve announcement on its future asset purchases is a case in point. In a few days, significant amounts were withdrawn from funds invested, in particular, in emerging bond markets. The subsequent sales and repatriation translated into capital outflows from major emerging economies and significant movements in exchange rates. In the future, this may be one of the main financial stability risks confronting policymakers in emerging economies.

A third source of concern is the herding behavior that naturally affects asset management. As well documented in the literature, the tendency to herd comes naturally from the set of incentives that managers face with their performance compared to others and assessed over short term horizons. It may also result from the business models and product structures. With similar mandates, asset managers hold similar portfolios and react similarly to a change in the environment. Also, some funds, such as ETFs, are specifically designed to offer an exposure to broad indices of securities, increasing the similarities between them. Herd behavior may also come from the original investors themselves: there is evidence that inflows and outflows in open funds invested in EMEs are strongly procyclical and heavily influenced by changes in overall risk aversion.

All those risks have increased in recent years. In an environment of exceptionally and durably low interest rates, investors’ search for yield has led them to look for assets with high returns, which are often those with less liquidity. Future shocks may come from those parts of the financial system that are most exposed to interest rates and liquidity risks. Shadow banking, in a broad sense, and non-bank intermediation, may be at the center of any future financial tensions and crises. It is even more important that they are appropriately regulated.

2. Conceptual Challenges in Regulating Shadow Banking and Asset Management

Shadow banking entities are intrinsically fragile because their function is to undertake maturity transformation. They are subjected to runs, vulnerable to changes in risk perception and loss of confidence, exposed to market illiquidity
and may behave in a strongly procyclical manner. They pose multiple and difficult challenges to regulators.

All those problems and potential risks have been very aptly diagnosed and analyzed (FSB, 2017 and IMF, 2015). However, devising a comprehensive policy response has proved very challenging.

Important reforms have been implemented. The rules regarding securitization have been strengthened in the aftermath of the crisis. Most significantly, a major reform of Money Market Funds has been introduced in 2016 in the US. So-called “prime MMFs” (non-invested in Government bonds) were allowed to suspend redemptions and forced to issue shares with floating net asset value (NAV). Following that reform, more than USD 1 trillion were withdrawn from Prime Funds and transferred to Government Funds with fixed NAV.

Important challenges remain in designing a proper and comprehensive regulation. The terminology does not help. Designating those activities as “shadow banking” implies a closeness to - and a similarity with - banking. It creates a presumption that the regulation of market-based finance should be inspired by and transposed from what has been done for banks. On the contrary, shadow banking raises very complex and specific difficulties that have not yet been fully addressed.

To regulate funds, authorities are confronted with a very imperfect choice of instruments. They can either replicate banking regulation with such instruments as capital and liquidity buffers, which are broadly ill-adapted to the task; or use specific tools, such as redemption limits and “gates”, that remain untested. None of those instruments offer a protection against a broad-based, systemic liquidity shock.

Banking regulation since the crisis has been rightly - and successfully - organized around one dominant objective: make financial institutions and the whole financial system more resilient by building strong buffers, both on capital and liquidity. Buffers are well adapted to banking activities that face leverage and credit risk. However, those are not the main risks attached to shadow banking – which rests upon maturity transformation – and it is doubtful that buffers can bring efficient protection. A capital buffer protects efficiently against losses, but very imperfectly against runs. It may be that investors will hesitate to run on a well-capitalized institution. But maybe not. The logic is very specific and totally self-fulfilling: people will run on a bank or a fund if they think others might do it, irrespective of the fundamentals and capital situation. The biggest run in modern history occurred on a bank, Northern Rock, that was extremely well capitalized. In addition, capital requirements would not help those funds that act as agents – not principals – and manage other people's money with the risks borne by investors themselves. Those funds do not put their own balance sheet to work and capital ratios, would be, in that case, largely irrelevant.
What about liquidity buffers? They certainly can act as shock absorbers when an intermediary of a fund suffers temporary and unexpected withdrawals. Supervisors are generally very attentive to the liquidity risk management by funds. They frequently require that liquidity levels be tested against stressed scenarios with unexpected withdrawals. Indeed, evidence shows that funds that engage into greater maturity transformation keep higher liquidity buffers. Liquidity ratios, therefore, seem appropriate to protect one specific institution from temporary withdrawals. They might not work when the whole system is facing an aggregate, common, and highly correlated liquidity shock. In that case, the level of buffers necessary to ensure the safety of the system would be so high as to prevent any maturity transformation at all.

In addition, or in substitution, to buffers, fund managers or regulators may consider and use so called “exceptional liquidity risk management tools”. Elaborate guidance usually exists, in many jurisdictions, to allow a fund, or its supervisors, to put limits to, or temporarily suspend, redemptions in pre-specified circumstances. Those “gates” could be very efficient as they directly address the immediate source of difficulties by preventing a run to occur. Their systemic impact is uncertain. There is a possibility that putting a gate on an important fund would trigger runs on other, similar, intermediaries and create a more widespread panic. In 2007, BNP Paribas, acting as an asset manager, suspended redemption on one of its funds citing difficulties in valuing illiquid assets. That measure is considered to have played some role in triggering the subsequent events that led to a paralysis on interbank and short-term markets. Overall, gates, as a tool to manage liquidity risk, remain untested.

With only unadapted (buffers) or untested (gates) tools at their disposal, what should regulators do?

They should certainly maintain a continued vigilance on the level of maturity transformation in different parts of the system, on market liquidity and potential adverse dynamics. The terms “close monitoring” are the most often quoted in policy papers relating to shadow banking and asset management. The dominant recommendation is to develop the reporting obligations by the main actors. It is both reassuring and a sign that regulators are still in the learning curve in terms of the appropriate regulatory response.

What may be missing at this stage is a macro prudential approach to shadow banking supervision. Shadow banking involves a multiplicity of actors and, consequently, a multiplicity of regulators. Each of those regulators, whether responsible for banks, markets or insurance, or pension funds has made sure they have the appropriate powers and tools to effectively supervise and protect the institutions in their perimeter. Current regulations are mainly oriented towards investor protection (IMF, 2015). However, the major risks attached to shadow banking arise from the interactions between different types of participants, through
the whole chain of intermediation and maturity transformation. The behavior of the system cannot easily be deduced from the actions of each participant. A macro prudential perspective is therefore essential to control the risks coming from complex dynamics and interactions between actors with different objectives and mandates. Stress testing is a central tool. And closer cooperation between banking, securities and insurance regulators is an absolute necessity.

Finally, one important question looms over the debate on shadow banking, although very often not made explicit. Should shadow banking benefit from some kind of public liquidity support and backstop in the form of a specific lender of last resort? Some of the ad hoc facilities created by the Federal Reserve during the Great Financial Crisis (GFC) were aimed at preventing a market freeze in shadow banking by providing liquidity to specific instruments (ABS, commercial paper) or institutions (money market funds). Within the new legal framework created by the Dodd-Frank Wall Street Reform and Consumer Protection Act, most of those facilities could not exist anymore. In normal times, most of the shadow banking, and the mutual fund industry, are outside the reach of central banks. Extending liquidity support to market-based finance would raise very difficult issues of moral hazard. Actors on securities market are expected to assess and control their risks and bear the consequences of their acts. Considering the growing systemic importance of shadow banking and asset management, however, it is difficult to anticipate that authorities would remain passive in the event of a major shock.

**Conclusion: Some Final Thoughts**

It is commonly assumed that the expansion of shadow banking is mainly driven by regulatory arbitrage, the desire to circumvent the capital and liquidity requirements that have been progressively imposed on banks. There is, of course, an element of truth in that assumption. Shadow banking itself has morphed into a different system with changes in regulations. The long chain of intermediation through securitization and repos has partially given way to a shorter channel of maturity transformation through mutual funds.

However, other, deeper, forces are at work. Shadow banking does not exist in a vacuum. The economy as a whole “demands” maturity transformation. Shadow banking has developed because it fills a need. Savers - and those institutions that represent them - want to keep parts of their assets in liquid form. They also want to earn some return. At the other end of the chain, productive investors need stable financing and long-term commitment.

Reconciling those opposite preferences has been a central role of all financial systems since the beginning of the world. What we call shadow banking is just the latest phase in this evolution. It’s getting increasingly sophisticated, complex, and potentially dangerous. But it is also increasingly necessary.
The need for maturity transformation is especially high in the current world environment where many sources of uncertainty combine to increase the demand for safe and short-term liquid assets. And, contrary to basic intuition, financial innovation has not attenuated the demand for liquidity and subsequent desire for maturity transformation. On the contrary, financial innovation creates the impression that it is possible for investors to conciliate, without limits, liquidity and return.

Regulators must determine to which extent this is a realistic aspiration. They must clarify the major tradeoffs involved. They must decide on whether to accommodate the desires of savers and investors – with associated dangers – or to refrain and constrain them. Should some forms of intermediation – or some products, be prohibited? Should the corresponding risks be partly assumed by the society through some form of public support because it would be decided that maturity transformation is a public good? There is no definite answer to those questions. They certainly deserve consideration as modern financial systems move away from traditional - bank based - into more market based financial intermediation.

Editor’s note: With the rise in financial stability risks caused by the expansion of shadow banking, it may be tempting for policymakers to assume that the traditional banking sector, bolstered by the reforms put in place after the Great Financial Crisis, will not be a likely source of financial crises in the future. This is a dangerous assumption.
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Shadow Banking, Financial Technology (FinTech), and Financial Inclusion – Three Pathways of Rapid Change in the Financial Services Industry

Summarized by Glenn Tasky

Executive Summary

2017 and 2018 were years of rapid transformation in the financial services industry. In most parts of the world, ten years after the start of the Great Financial Crisis (GFC), financial institutions (FIs) were better capitalized and had more stable funding and assets with a higher degree of liquidity than had been true for many years. They were more resilient than before to the types of shocks that had rocked the world in the previous decade.

However, traditional FIs could not sit back complacently. Since the GFC, customers – both households and firms -- had changed. They were no longer content with costly, slow service delivery in traditional banking areas such as payments, deposits, and loans. Governments demanded more action from FIs in extending formal financial services to excluded populations. Innovations in financial technology (FinTech) brought new players, such as e-commerce, gaming, and messaging service giants, into the financial services industry, threatening to erode margins. New, more widely available sources of customer and firm data cast doubt on banks’ comparative information advantage. Disintermediation became more of a possibility, as borrowers and lenders started dealing directly with each other, even in fairly small transactions. As the pressure to satisfy investors intensified in an era of low interest rates, misconduct intensified, resulting in large fines, costs of stepping up compliance activities, and further customer alienation.

The SEACEN Centre responded to these fast-paced developments by offering several new and restyled courses in 2017 and 2018, among them two offerings of the SEACEN-MAS FinTech Seminar (together with the Monetary Authority of Singapore), two offerings of the SEACEN Course on ICT Risks in Banks (with emphasis on cyber risks), the SEACEN Course on Anti-Money Laundering and Combating the Financing of Terrorism, and reconfiguring the three Payment Systems courses to emphasize 1) operations, 2) oversight and regulation, and 3) technology and emerging issues.

Two events, in particular, reflected on these fast-paced developments. In September 2017 SEACEN hosted two major events covering the financial sector in the Asia-Pacific region: the SEACEN High-Level Seminar for Deputy Governors of Financial Stability and Supervision (6-7 September) and the SEACEN Policy Summit on Shadow Banking (8 September). This overview summarizes selected presentations from these two events, which covered a wide range of topics including
financial inclusion, misconduct, problem bank recovery and resolution, proportional regulation, artificial intelligence and machine learning in banking and banking supervision, the incentives for the rise of shadow banking, and online marketplace lending.

The Relationship Between Financial Inclusion and Financial Stability:
Presented by Dr. Atiur Rahman, Professor, Department of Development Studies, Dhaka University; Chairman of Unnayan Shamannay Research Organization, and Former Governor, Bangladesh Bank

Dr. Rahman began by illustrating the virtuous circle between financial stability and financial inclusion. Financial inclusion, he emphasized, supports financial stability by providing banks with a more diversified funding and loan base. Individual financial institutions, in other words, are more resilient when they draw their funds from myriad small savers rather than just a few big firms or entities, and when they lend to a multiplicity of small borrowers rather than just a few big corporate clients.

In addition, the availability of formal financial services diminishes the appeal of unreliable savings channels such as local moneylenders and the Ponzi schemes that inevitably crop up in less-regulated markets with less-sophisticated and experienced investors. Finally, a more inclusive financial system has more political legitimacy, and can then avoid harmful and destabilizing interference from the public sector (such as punitive taxes or audits).

Even more profoundly, financial inclusion can promote stability and income equality at the household level, lessening the likelihood of systemwide consumption drops that could cause unexpected withdrawals from bank accounts or increased incidence of non-performing bank loans. And the effectiveness of monetary policy is enhanced when a large group of potential small borrowers is enticed to take out loans in response to a policy rate cut, rather than depending on the investment whims of a small group of large borrowers.

Financial stability, in its turn, can lead to greater financial inclusion. Profitable, liquid, and well-capitalized banks are better equipped than weak banks to shoulder the upfront costs of reaching out to previously-underserved markets, taking chances with new products and services to grow new clienteles. These new customers, for their part, are more attracted to stable financial institutions in which to save and from which to borrow. Stable financial institutions with healthy net interest margins are also better equipped to serve new customers with lower fees, fostering financial inclusion.
Dr. Rahman continued by describing some of the recent financial inclusion initiatives and accomplishments in Bangladesh. Among these initiatives are: support to the agricultural sector (including loans to tenant farmers and low-cost deposit accounts for all farmers), priority financing for small and medium enterprises (SMEs), promoting women entrepreneurs, allowing (and carefully regulating) agent banking, expanding mobile financial services, introducing a refinancing scheme for “green” products and services, and making low-cost accounts available for schoolchildren and street children.

Over the past few years, the Bangladesh economy has shown significant progress in maintaining steady economic growth with moderating inflation and exchange rate stability, reducing poverty, and widening and deepening the reach of financial services. While noting these accomplishments, Dr. Rahman concluded on a cautionary note: by its very nature, financial inclusion brings in people with no track record in the use of formal services, with no formal credit history, and with little financial literacy or experience in a formal setting. Such persons may be sold unsuitable or overpriced products and services, which would expose the entire system to reputational risk. In these settings, prudent regulation, including enforcement of consumer rights and a method of customer redress, is paramount.

The presentation was followed by a lively discussion of the relative challenges involved in supervising microfinance institutions (MFIs) vs. state-owned banks. Dr. Rahman pointed out that it was not necessary to license “microfinance banks,” per se; similar results could be achieved by encouraging commercial banks to lend to MFIs, and state-owned banks, even those tasked with microfinance and other financial inclusion mandates, could still end up with high stocks of non-performing loans due to unavoidable and unstoppable political influence.

“Regtech and Suptech”: Using Data Analytics and Technology to Streamline the Compliance and Regulatory/Supervisory Functions, Presented by Dr. David Roi Hardoon, Chief Data Officer & Head of Data Analytics Group, Monetary Authority of Singapore (MAS)

Dr. Hardoon noted that the Data Analytics Group at MAS was only established six months prior to his address to the delegates. According to Dr. Hardoon, the interest around data and analytics was more than a hype. He shared multiple examples of how much data and information we are creating and how we are consuming data. Using Twitter and Facebook as examples, he pointed out that Twitter users tweet about 277,000 times per minute, and Facebook users share about 2,460,000 pieces of content per minute.
In financial services the breadth of data is wide. From the regulator’s point of view, data includes but is not limited to transactional data, exposure/risk data, trading market data, financial statement data, macroeconomic data, news and reports, and complaints and misconduct reports. A key part of data analytics is looking beyond aggregates using the building block of data science.

In order to help participants understand the meaning of machine learning and artificial intelligence, Dr. Hardoon quoted Herbert Alexander Simon, the winner of the 1975 Turing Award and the 1978 Nobel Prize in Economic Science, who said “Learning is any process by which a system improves performance over experience”.

The Meaning of Machine Learning (ML) and Artificial Intelligence (AI)

ML refers to computer programmes that automatically improve their performance through experience (data). AI is a subfield of machine learning. Dr. Hardoon cited dynamic rules for AML/KYC as an example where machines using natural language processing (NLP) can be useful for named entity recognition without the power of the eye. This can be done through syntactic parsing which is the process of finding the immediate constituents of a sentence that is a sequence of words. Syntactic parsing is an important part of the field of natural language processing and it is useful for supporting a number of large-scale applications including information extraction, information retrieval, named entity identification, and a variety of text mining applications. Part of Speech (POS) Tagging is also a very basic and well-known NLP problem which consists of assigning to each word of a text the proper morphosyntactic tag in its context of appearance. It is very useful for a number of NLP applications: as a preprocessing step to syntactic parsing, in information extraction and retrieval (e.g. document classification in internet searchers), text-to-speech-systems, corpus linguistics, etc. The base of POS tagging is that many words being ambiguous regarding their POS, in most cases they can be completely disambiguated by taking into account an adequate context.

Noting that very rarely there are enough supervisors at any regulatory authority, he stated that ML and AI can be an enormous benefit to supervisors. For example, given that regulators typically receive a great many questions, chatbots can be used to automate responses. ML and AI can also be useful for sentiment analysis (“opinion-mining”). The machine translation can be accomplished using syntactic parsing and tagging to provide automatic question answering that is automatically adapted and customized to individual users. Other benefits and advantages of ML and AI include:

- Discovering new knowledge from large datasets
- Mimicking humans to replace certain monotonous tasks
- Developing systems that are too difficult or expensive to construct manually
The Meaning of Supervisory Technology (SupTech)

Dr. Haroon then made the distinction between regulatory technology (RegTech) and supervisory technology (SupTech). He noted that in the case of RegTech, the primary users are banks and other financial institutions, whereas with SupTech, the users are supervisors in regulatory authorities, such as central banks and monetary authorities. The main purpose banks and other financial institutions are driven towards RegTech is for regulatory compliance and reporting; for example, compliance with Basel III/IV and new AML/CFT regulations. Regulatory authorities are interested in SupTech to improve and create efficiencies for supervision and surveillance purposes.

Both RegTech and SupTech require great collaboration between regulators and financial institutions with the objective being managing and mitigating risks. It is critical to have a clear picture of where to start in the development/problem solving stage. Quoting Anthony Scirfignano, Chief Data Scientist, Dun & Bradstreet, the speaker told the audience that “You never lead with the data, and you never lead with the technology. You lead with the problem”. The Data Science Hierarchy of Needs provides a good foundation of where to start.

**Begin with the Right Foundation**
A key question is analytics linear or non-linear? There are four important pillars as shown below:

**The Data Value Chain**

Examples of use cases relating to RegTech include the following:

- Capital optimization
- Portfolio management
- Credit scoring
- Client-facing chatbots
- Trading execution

Dr. Hardoon shared an example of MAS’ Capital Markets Intermediaries Department researching text analytics on misconduct reports. The key objective for MAS is to leverage text analytics to distill insights and trends on misconduct modus operandi, and guide supervisory resources, for example to prioritise reports for review. He also shared an example of MAS’ Enforcement Department researching syndicated trading detection. In the problem statement MAS seeks to expand from event-driven alerting to algorithm-driven detection of collusive manipulation typified by certain behaviours e.g. pump-and-dump, layering, and circular trading.

**Ongoing Data Governance**

The speaker stressed the importance of ongoing data governance. A Data Governance Framework is a logical structure for classifying, organizing, and communicating complex activities involved in making decisions about and taking action on enterprise data. All organizations need to be able to make decisions about how to manage data, realize value from it, minimize cost and complexity, manage risk, and ensure compliance with ever-growing legal, regulatory, and other
requirements. Management and staff need to make good decisions – decisions that stick. They need to reach consensus on how to “decide how to decide.” They need to create rules, ensure that the rules are being followed, and to deal with noncompliance, ambiguities, and issues.

MAS’ ongoing data governance efforts include:

- MAS Data Catalogue
- Data collection platforms
- Digitization initiatives

Dr. Hardoon also made the audience aware of MAS’ upcoming data initiatives, including

- MAS private cloud
- Review of data classification
- Data cleaning framework

For MAS the core capability requirements to becoming a data-driven organisation are:

![Data-driven organisation diagram]

It is also important for MAS to have the right mindset -- including to empower the workforce, embrace experimentation and infrastructure, and engineer change. Management should also ask the right questions:

1. Does the project align with strategic objectives?
2. What are the dependencies and risks?
3. Has bias in the data been addressed?
4. Are the algorithms appropriate and the results robust?
5. Are the results interpretable and generalisable?
Dr. Hardoon ended his presentation with a quote from Jim Barksdale, former Netscape Communications Corporation CEO “If we have the data let’s look at the data. If all we have are opinions, let’s look at mine.”

Challenges in Supervisory Assessments of Banks’ Values and Conduct: Control Frauds, Misconduct Risk, and Whistleblowing; Presented by Richard M. Bowen, Senior Lecturer in Accounting, Jindal School of Management, University of Texas at Dallas, and Founder of Bank Whistleblowers United

Mr. Bowen, who previously had a long career as a senior mortgage officer at a large American bank (“the Bank”), warned about regulatory laxity and the reluctance of bank regulators to make criminal referrals to law enforcement bodies. External auditors, as well, often do not catch fraud and insider abuse until it is too late, and many bank failures could have been prevented with more diligent external auditing and more intensive supervision.

In introducing the topic of values and conduct, Mr. Bowen emphasized that watching for and reporting illegal or unethical conduct in banks is the responsibility of every bank employee. If unethical behaviour is tolerated at any level, it will tend to spread throughout the bank, and codes of ethics are necessary, but not sufficient, to reduce the risk of misconduct.

These observations come from Mr. Bowen’s own experience as a business chief underwriter for the Bank in the mid-2000s, when he observed that low-quality mortgages that the Bank would not keep in its own portfolio were being originated and bought by the Bank and sold to the United States mortgage giants Fannie Mae and Freddie Mac, and other investors, as if they were high-quality mortgages. He warned the Bank’s Board and senior management repeatedly that this practice was ongoing and was not only fraudulent, but also in violation of shareholder disclosure laws. Mr. Bowen recommended that the Board engage a third party to conduct an investigation of these fraudulent practices.
Instead of rewarding him for pointing out this misconduct, the Bank relieved Mr. Bowen of his responsibilities. The Bank also fired another whistleblower, who informed the U.S. government of the fraudulent activity. Ultimately, the government reached a settlement with the Bank, wherein the Bank paid a $158 million fine (of which $31 million was granted to the whistleblower). The Bank, however, continued to originate low-quality mortgages even after paying the fine.

Mr. Bowen was not as well-treated financially as the other whistleblower. He was invited to testify before the Financial Crisis Inquiry Commission (FCIC) in 2010, but parts of his testimony were scrubbed from the official record. The U.S. government put a 5-year embargo on these suppressed portions of testimony, exactly the same as the statute of limitations for fraud. Even so, Mr. Bowen's testimony did have some impact: the FCIC made 11 criminal referrals against nine individuals based on his testimony to the Department of Justice. The Department, however, refused to prosecute any of the individuals cited.

Mr. Bowen concluded with a brief discussion and warning of “control fraud,” the uncommon, but devastating, situation where bank Board directors and senior management orchestrate massive frauds that ultimately cause the bank to fail. He explained that owners and managers can, by engineering supranormal shareholder returns (with concomitant bonuses and share buybacks) for a short period of time, reap huge rewards from a bank that eventually fails with zero shareholder value. The main tools of control fraud, accounting fraud and appraisal fraud, allow high-yielding but inherently problematic (and even fictitious) loans to be made and sometimes sold, with loan-loss provisions underreported and default probabilities understated. Impressive earnings now make the directors and senior management wealthy, with large losses coming later, largely borne by the taxpayer as resolution costs.

Key in the control fraud strategy is training employees not to ask the right questions and not to speak up. Senior management often sets overly ambitious targets and punishes employees who fail to meet the targets. Retaliation against internal and external whistleblowers helps spread the message that going along with the illegal or unethical practices is the key to surviving and thriving in the organization.

Mr. Killeen focused on the setting up of the EU Shadow Banking Monitor by the ESRB, to aid its objective to prevent and mitigate systemic risk to financial stability.

Shadow Banking Typology and Links Between Shadow Banking Entities and the Banking Sector, Presented by Neill Killeen, Member of the European Systemic Risk Board (ESRB) Secretariat

Mr. Killeen focused on the setting up of the EU Shadow Banking Monitor by the ESRB, to aid its objective to prevent and mitigate systemic risk to financial stability.
The ESRB’s methodology for monitoring shadow banking activity applies entity-based and activity-based approaches, which map broad shadow banking system in the EU.

1. **Entity-based mapping**: Examines investment funds, financial vehicle corporations, non-securitisation special purpose entities, security and derivative dealers, and financial companies engaged in lending.

2. **Activity-based mapping**: Focuses on horizontal shadow banking risks from financial markets which cut across entities (securities financing transactions and derivatives).

The Monitor focuses on the extent of liquidity and maturity transformation, leverage, interconnectedness with the regular banking system and credit intermediation.

The ESRB’s May 2017 Shadow Banking Monitor¹ showed that the EU’s shadow banking exposure stood at an estimated EUR 40 trillion, or 28% of the EU’s financial sector. It grew by 2.6% in 2016, and had grown by 30% from 2012-16. EU banks in total have exposures of EUR 559 billion to shadow banking entities – approximately 4.3% of EU GDP. “Financial Vehicle Corporations” (FVCs) are securitization entities which are an important and growing component of the shadow banking market, and have close relationships with banks.

Shadow banking in Asia is still estimated to be fairly small, but growing faster than in any other area of the world. Mr. Killeen emphasized that there are no observable links yet between shadow banks in Asia and either commercial banks or shadow banks in Europe.

The key risks and vulnerabilities identified in the EU shadow banking system were:

- **Liquidity risk and risks associated with leverage** among some types of investment funds (e.g. investment funds which invest in less liquid markets while offering daily redeemable shares or are highly leveraged).

- **Interconnectedness and contagion risk** across sectors and within the shadow banking system, domestic and cross-border linkages.

- **Procyclicality, leverage, and liquidity risk** created through the use of derivatives and securities financing transactions.

- **Significant data gaps** for some types of other financial institutions.

Going forward, the ESRB will focus on the following areas:

- Employing EU wide regulatory data to monitor developments within the EU shadow banking system and monitoring other shadow banking developments globally.

- Make use of micro-data to complement sectoral data, e.g. new regulatory data such as the Alternative Investment Fund Managers Directive 2011/61/EU (AIFMD) data on alternative investment funds, European Market Infrastructure Regulation (EMIR) data on derivative transactions, and Securities Financing Transaction Regulation (SFTR) data on securities financing transactions to further develop the monitoring framework.

- Risk monitoring: Extend breadth and depth of risk indicators and metrics.

- Improve coverage and meta-data (e.g. consolidation of entities).

- Assess the geography of risk (e.g. interconnectedness, cross-border issues).

**Online Marketplace Lending / Peer-To-Peer (P2P) Lending: Business Models, Risks, and Regulation, Presented by Kieran Garvey, Head of Regulation and Policy, Cambridge Centre for Alternative Finance**

Mr. Garvey began with a taxonomy of the “alternative finance landscape,” consisting of non-bank, generally technology-focused firms engaging in equity finance (primarily SMEs and real estate crowdfunding), virtual currencies (initial coin offerings and cryptocurrencies), and, most important for shadow banking, lending (peer-to-peer business, peer-to-peer consumer, and peer-to-peer property). He pointed out that all of these types of alternative finance are much more common in China than in the United States or United Kingdom, but that in China, there is much less institutional funding and much more household funding for alternative finance, raising issues of consumer protection. Indeed, China’s total stock of alternative finance is estimated to have reached nearly USD 250 billion, vastly dwarfing the other regions of the world, collectively estimated at less than USD 50 billion. And, of all these types of alternative finance, P2P lending is the most dominant.

Globally, the potential market is much greater – the sum of potential unsecured personal loans, small business loans, student loans, and mortgages – has been estimated at USD 4.6 trillion. While this estimated worldwide market for P2P lending looks promising for financial inclusion, low-income countries have been slow in embracing the new technology.
Many countries are embracing P2P lending. In Southeast Asia, Singapore and Indonesia are the most active, while there is an emerging market in Malaysia, Thailand, and Vietnam. East Asian activity is dominated, of course, by China, whose total lending activity in 2015 (flow, not stock) exceeded USD 50 billion. However, South Korea and Japan have also shown significant activity. In South Asia, only India shows any activity, while in Oceania, New Zealand’s P2P market has taken off rapidly, while Australia is also booming. Outside of Asia, the U.S., and the U.K., the most active countries are Germany, France, Finland, Estonia, and Canada.

Mr. Garvey explained that in the subset of P2P consumer loans, at least for the U.K., the top uses are for buying vehicles, consolidating debt, and undertaking home improvements. For P2P business lending, the most important categories are borrowing for expansion and growth, for working capital purposes, and for covering legal costs.

The risks and challenges of this growing form of shadow banking, Mr. Garvey explained, can be categorized as risks and challenges to regulators, risks and challenges to investors, and risks and challenges to platforms. For regulators, it is not a simple task even to identify and monitor all new and existing platforms, which currently number over 4,000. Many have already failed.

Regulators are also concerned about whether the P2P lenders have used appropriate judgment and credit risk analysis in making loans, and whether “adverse selection” is at play – borrowers going to P2P lenders who have been rejected by banks. In addition, Mr. Garvey cited problems with data transparency, reporting performance of loans, and the inappropriate segregation of client moneys (using client moneys for hedging, speculating, covering operational expenses, etc.). And, because the activity is growing fast, there are many opinions, but little consensus, on whether P2P lending poses systemic risk.

Mr. Garvey continued by discussing several risks to investors, many of whom are individuals and households. Notably, if investors are not financially literate, they may not properly diversify, and place a disproportionate amount of their assets with one P2P platform or even with one borrower. Moreover, investors may not fully understand the risks, which could include loss of the entire investment. There is always also the possibility of platform or borrower fraud and malpractice. Loans to certain borrowers may be in an amount, or with an interest rate, that is unaffordable to the borrower, leading to defaults and losses of investor funds.

Risks to P2P lending platforms must also be taken into account, Mr. Garvey argued. First of all, P2P borrower assessment by means of a credit score has not yet been rigorously tested. Next, there is a lack of regulatory clarity, as jurisdictions around the world are considering various regulatory approaches. Cybersecurity is a
primary concern, as it is with all FinTech platforms. And in the “rush to market,” many platforms may suffer from insufficient due diligence, incompetence, or mismanagement.

Mr. Garvey concluded by announcing the launch of the World Bank – Cambridge Global Alternative Finance Regulator Survey, which will canvass over 100 regulators, both central banks and securities commissions, to do a stocktaking of existing frameworks, specific regulatory requirements, and types of data and data-sharing that exist throughout the world.

Financial Inclusion and Proportionate Regulation: Does Regulation Help or Hinder Financial Inclusion? Presented by Dr. Atiur Rahman, Professor, Department of Development Studies, Dhaka University; Chairman of Unnayan Shamannay Research Organization, and Former Governor, Bangladesh Bank

Dr. Rahman began by outlining the dilemma: the absence of adequate regulation may allow a credit bubble to develop, causing a generalized financial crisis, but if regulation is too stringent, many creditworthy people will be denied access to all financial services, including loans. Moreover, excessive regulation of financial intermediaries can cause investment to stagnate, and foster the development of questionable “shadow banking” activities that may also lead to instability. And, if financial inclusion is not pursued as a goal in building a regulatory regime, banks will be too dependent on their large, corporate borrowers, whose dominance not only among bank customers but in the overall economy is also a potential source of instability.

While regulation is often viewed as stifling economic activity, Dr. Rahman pointed out that well-tailored regulation can actually enhance financial inclusion. For example, requiring interoperability among mobile network operators (MNOs) encourages far more people to utilize mobile financial services than if each MNO ran its own self-contained system. “Know-your-customer” (KYC) or “customer due diligence” requirements to prevent money laundering and to combat the financing of terrorism can seem to inhibit financial inclusion of clients who do not possess adequate documentation, but they can be made less onerous by allowing the opening of a restricted account pending submission of the full set of documents. Technology, as well, can assist in speeding up the required identification of customers.

As for mobile financial services, Dr. Rahman indicated that Bangladesh chose a “bank-led” model from the beginning, eliminating the need for the financial sector regulatory authority to supervise the collection of customers’ funds by the MNOs. Customers of mobile financial services increased in number from practically zero in 2012 to more than 40 million in 2017. Mobile financial services
are used by the Bangladesh government for social security payments, including to 40 million mothers. Dr. Rahman also encouraged the audience, many of whom were bankers or bank regulators, to explore partnerships between non-governmental organizations and banks, because NGOs can assist in the all-important tasks of identifying suitable borrowers, thereby meeting credit risk management guidelines while pursuing inclusion at the same time. This approach has proven successful in increasing loans to tenant farmers in Bangladesh. “Agent banking” can also foster financial inclusion, while delegating to the banks that use agents the responsibility of proper risk management in the selection of agents.

Regulation that requires customers to be better informed about the terms and conditions of banking products, together with a mandatory redress of customer complaints, can also promote financial inclusion. More knowledgeable customers of any product or service tend to use more of that product or service, especially if they know that their rights are protected if providers engage in deception or other misconduct.

Above all, Dr. Rahman stressed, it must be recognized that global financial regulatory standards are set with the largest banks in mind, and may not always fit smaller banks or those in less-developed banking markets. It is encouraging, he said, that standard-setters are now beginning to recognize this possible drawback, and more fully embracing the idea of proportional regulation with the assistance of technology.

Financial Inclusion and Proportionate Regulation: Does Regulation Help or Hinder Financial Inclusion? Presented by Dr. David Mayes, Professor of Banking and Finance, University of Auckland Business School

In his presentation, Dr. Mayes reviewed various regulatory approaches to so-called “digital currencies,” (DCs), also called “virtual currencies” or “cryptocurrencies.” Distinguishing between privately-issued DCs, such as bitcoin, and central bank-issued DCs, he noted that the proliferation of privately-issued DCs and their volatility reduced the likelihood that any one of them would gain a foothold, either as a medium of exchange or a store of value.

As for central bank-issued DCs, he saw a brighter picture. These official DCs could be exchanged between financial institutions, could be exchanged between individuals through mobile financial services (fostering financial inclusion), and could be used whenever a central bank wished to stimulate the economy through dropping “helicopter money.” Ultimately, central bank-issued DCs could replace banknotes and coins on the liability side of central bank balance sheets, providing a safer (and more easily traceable) means of payment in all transactions for which cash is normally used today.
1. Introduction

My purpose in this article is to share some of the policy thinking behind New Zealand’s use of macro-prudential policy over the period from 2013 to 2016. Many Central Banks, including SEACEN members, have been considering or using macro-prudential policies with the common aim of reducing systemic risk in the housing market. The post-GFC environment has seen persistent low inflation and easy monetary conditions globally, leading to an expansion of debt and asset markets in many countries at the same time as goods and services inflation has remained moderate. While the growth in debt and house prices have given rise to financial stability concerns, there has been little scope for monetary policy to assist. Financial authorities have turned to other instruments, such as macro-prudential policy, to help achieve their financial stability objectives.

Many of the policy issues faced in New Zealand are specific to the New Zealand market, but there are also many common elements that have relevance internationally. It is these issues of broad relevance that I will focus on. The article commences with the New Zealand macro-prudential framework and the reasons for the LTV measures taken. It then reviews the policy experience and offers some lessons learned that might assist other Central Banks in improving their macro-prudential frameworks.

2. Motivation for Macro-prudential

Two important lessons from the GFC were: 1) that the real economic costs of a systemic financial crisis can be large and long-lasting; and 2) there is a need to assess systemic risk from a macro perspective, not just through cumulative micro-based assessments. With these lessons in mind, the emergence of significant housing imbalances in the post-GFC low-interest environment prompted many Central Banks to consider alternative policy responses, including macro-prudential policy.

Of course, not every housing cycle warrants a macro-prudential response. Housing cycles can have multiple causes, real and financial, and they may or may not present a systemic threat. House price increases can be seen as a market response to bring out extra supply to meet the needs of a growing population, so there is a default case to let the price mechanism work. To view house prices as a

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1. Thanks to Hans Genberg and Bernard Hodgetts for comments on an earlier draft.
systemic threat, there needs to be evidence of a significant speculative element, fuelled by credit, that could rapidly correct, presenting a heightened prudential risk. This provides the rationale for imposing transitional and additional prudential requirements while the heightened risk persists.

In the post-GFC environment in New Zealand, we had low interest rates and easy credit conditions, combined from around 2012 with a significant pickup in immigration. So, credit was an important driver but not the only driver. Financial stability concerns became apparent in two important respects: First, systemic housing risk appeared to be increasing as house prices continued to outpace nominal incomes. House price to income ratios (at least for Auckland) were amongst the highest in the world, pointing to a heightened risk of a housing market correction which could seriously impact the banking system. Second, the banks appeared to be contributing to this worsening risk situation through an easing of lending standards.

These two factors together made a strong case for macro-prudential policy: heightened systemic risk from a credit fuelled housing boom and the banks actively contributing to the expansion through easier lending standards.

3. The New Zealand Macro-prudential Framework

3.1 Relationship between the Reserve Bank and the Government

The existing Reserve Bank Act (Part V covering prudential regulation) was sufficiently flexible to allow implementation of a macro prudential policy using existing Reserve Bank of New Zealand (the Bank) prudential powers. However, this was a new policy approach that was never envisaged at the time the Act was passed (1989) and it was also expected to have a higher public profile than conventional prudential policy. For this reason, in May 2013, a Memorandum of Understanding (MOU) was put in place between the Bank and Minister of Finance to clarify the key elements of the new macro-prudential policy framework.

The MOU established the Bank as the macro-prudential policy decisionmaker but required consultation with the Minister and Treasury if any macro-prudential intervention was under active consideration. The objective set down for the policy is to increase the resilience of the financial system and to counter instability in the financial system arising from credit, asset price or liquidity shocks. The policy is therefore intended to provide additional buffers to the financial system that are expected to vary with the credit cycle. The MOU sets out four policy instruments that may be used for macro-prudential policy, as set out below in Figure 1. Any addition to the policy toolkit needs to be undertaken in consultation with the Treasury.

The Bank is required to be fully accountable for its macro-prudential actions to the Bank’s Board, to the Minister and to Parliament, publishing its systemic risk assessments and reviews of policy impact in the Bank’s Financial Stability Reports.

The MOU further requires that a review of the MPP framework be conducted after five years. This review was underway at the time of writing in November 2018.

**Figure 1. The Available Policy Instruments**

<table>
<thead>
<tr>
<th>Policy Instrument</th>
<th>Description</th>
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<tbody>
<tr>
<td>Loan to Value Ratios (LTV’s)</td>
<td>Known locally in NZ as “LVR’s”</td>
</tr>
<tr>
<td>Countercyclical capital buffer (CCB)</td>
<td>Widely adopted Basel 3 instrument which adds up to 2 1/2% to the CET1 requirement through the cycle</td>
</tr>
<tr>
<td>Sectoral capital requirements (SCR)</td>
<td>Additional capital buffer applied to a particular sector</td>
</tr>
<tr>
<td>Core Funding Ratio (CFR)</td>
<td>An existing prudential liquidity ratio (akin to the Basel NSFR) that could be varied to counter a liquidity shock</td>
</tr>
</tbody>
</table>

3.2 **The Decision-making Process**

Briefly describing the Bank’s internal decision process, management papers reviewing systemic risk and policy options are prepared by the Bank’s prudential analysis team and these are discussed at regular prudential policy committee meetings chaired by the Deputy Governor. The Bank’s Governing Committee decides which policy options if any to take forward for discussion with Treasury and the Minister. If the Minister (advised by Treasury) agrees, then a policy measure is announced, to be implemented at a future date subject to consultation with the banks and the public. The final calibration of the LTV policy measures was significantly influenced by the consultation process.

4. **Emerging Housing Risks: 2012-2013**

The boom in residential property that developed, particularly in Auckland, in 2012-13 was founded in a physical shortage of houses but exacerbated by growing investor demand. The physical shortage arose from supply constraints in the face of strong net immigration which was adding 1.0-1.5% per annum to population growth. Supply was constrained by skill shortages, inefficient construction and development sectors and major delays in consenting processes.

3. The advent of macro-prudential policy has led to a significant improvement in the Bank’s measurement and analysis of systemic risk; see for example the regular macro-prudential chart pack: https://www.rbnz.govt.nz/-/media/ReserveBank/Files/Financial%20stability/Macro-prudential%20indicators/2018/MPI-chartpack-sep-2018.pdf?la=en
At the same time there was evidence that investors were accounting for an increasing share of house sales and new mortgage credit, the share reaching around 40 percent. This was resulting in a downward trend in home ownership and a declining trend in the rental yield. The fact that investors were continuing to increase their residential property portfolios even when the rental yield fell to the level of bank deposit rates suggests that expectations of capital gains were dominating expected total returns. There was little doubt that credit-fuelled speculation was exacerbating the underlying physical housing shortage.

Adding to systemic risk, house prices were beginning to look very stretched in terms of price to income ratios and banks were lending an increasing proportion of funds at high LTVs and high DTIs. Banks individually argued that their capital was adequate to cover the higher share of risky lending, but individual bank calculations did not allow for the fact that their own lending strategies were, in aggregate, tending to increase systemic housing risk.

In summary, the key factors driving the case for macro-prudential measures were:

- Rapid growth in house prices and new mortgage credit
- A high degree of “stretch” in house prices relative to incomes
- An increasing share of high LTV lending and declining lending standards generally
- Increasing shares of house sales and credit going to residential property investors

4.1 The LTV Measures

Once the case for macro-prudential policy had been made, a range of instruments were considered, including sectoral capital requirements and the counter cyclical capital buffer, however LTVs were the preferred tool. While bolstering bank balance sheets, capital overlays were thought to have a relatively weak and uncertain impact on the credit cycle. It was unclear the extent to which capital overlays would be absorbed within existing excess capital holdings and the impact on the banks’ overall cost of funds was assessed to be relatively small. In an environment of aggressive competition for new mortgage lending, the Bank considered it unlikely that capital overlays would have any significant impact on the volume of credit expansion. LTVs, on the other hand, were considered likely to have a moderating impact on credit growth as well as reducing risk in bank balance sheets.

Further supporting the case for LTV restrictions, they were seen as a direct response to the increasing proportion of high-LTV lending that had reached 35-38% for new lending, compared to around 20% for the existing stock of mortgages. Also, it was felt that systemic housing risk would be improved more effectively and

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4. The Bank did however raise the risk weights on high LTV lending.
unambiguously by reducing expected bank losses through LTVs than by increasing
the banks capacity to absorb those losses through higher capital. Certainly, this is
consistent with the general principle that prudential oversight needs to focus on
maintaining the quality of assets, not just on capital adequacy.

Three rounds of LTVs were applied under the new policy framework in Oct
2013, Nov 2015 and Oct 2016, with a degree of easing applied in Jan 2018. These
measures are summarised in Figure 2, below. The initial Oct 2013 measure was
broad-based, applying an 80% “high LTV” threshold and a “speed limit” of 10%. Subsequent measures added a tighter requirement for Auckland investors (Nov 2015) and then investors nationally (Oct 2016).

Figure 2. LTV Measures Applied Over 2013-2018

<table>
<thead>
<tr>
<th>Month</th>
<th>Measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 2013</td>
<td>10% speed limit on LTV&gt;80%</td>
</tr>
<tr>
<td>November 2015</td>
<td>Additional overlay of:</td>
</tr>
<tr>
<td></td>
<td>5% speed limit on Auckland investors with LTV&gt;70%</td>
</tr>
<tr>
<td>October 2016</td>
<td>Auckland overlay replaced by:</td>
</tr>
<tr>
<td></td>
<td>5% speed limit on all investors with LTV&gt;60%</td>
</tr>
<tr>
<td>January 2018</td>
<td>5% speed limit on investors with LTV&gt;65%</td>
</tr>
<tr>
<td></td>
<td>15% speed limit on owner-occupiers with LTV&gt;80%</td>
</tr>
</tbody>
</table>

In terms of the design specifications of the LTV measures, I will elaborate on
three aspects: the use of “speed limits”; the approach to exemptions; and anti-avoidance.

Why should we use a speed limit rather than a prohibition of high LTV
lending? The main reason was to simplify the implementation of the measures. With
any regulatory imposition of this sort there are always special cases and anomalies
that warrant exemption in addition to the agreed broad classes of exemptions.
Having a speed limit avoids the need for a detailed list of exemptions and gives
banks a degree of “wriggle room” in implementing the measures. In this regard, the
Bank felt that the likelihood of non-compliance (accidental or otherwise) would be
reduced by the use of speed limits. The added degree of flexibility would make the
measures more efficient as well as being more palatable to the banks in terms of ease
of implementation.

After consultation with the banks, a number of exemption classes were defined
for the LTV measures including loans for home construction and remediation,
refinancing loans and government supported low income housing loans. First home

5. This meant that 10% of a bank’s new mortgage lending could be above the 80% LTV threshold. The
“speed limit” metaphor is chosen to give the idea of slowing down, but not stopping.
buyers were not exempted, despite considerable political pressure to do so. The Bank felt that such an exemption could not be justified on any prudential grounds. The construction exemption was included so as not to constrain new building activity that could help to alleviate the housing shortage. However, most lending on new builds is at moderate LTV levels to allow for uncertainty around ultimate collateral value, so this exemption has probably not made a big difference to the impact of the policy. The refinancing exemption was to allow borrowers to shift house or bank even though they may have an existing high-LTV loan. Any top-up concurrent with refinancing requires that the whole loan amount be subject to the LTV policy. A further exemption was made for loans made against the combined collateral of a property portfolio. A new investor loan may be exempt from the LTV policy if there is sufficient excess collateral available in the borrower’s overall portfolio.

An important further aspect of the LTV design is the anti-avoidance clause. This clause requires that banks should not enter into any arrangement to avoid the LTV restrictions. It gives specific examples of avoidance such as banks funding non-bank mortgage lenders or funding mortgage deposits through personal loans. The clause also makes the general point that the Bank will pursue any bank that puts in place arrangements that appear to circumvent the policy. In the early days of the policy it was necessary for the Bank to firmly enforce this clause as a number of avoidance schemes emerged. It was necessary to act quickly and firmly to nip any avoidance in the bud.

5. The Policy Experience

I will consider four areas of the New Zealand LTV experience: 1) the impact on the housing cycle (the most visible and high profile area); 2) The impact on systemic risk in the banking system, i.e., the prudential impact; 3) the degree of leakage or disintermediation arising from the policy; and 4) the impact on the behaviour of stakeholders, including the banks and other policy makers.

First considering the impact of the policy on house price inflation, Chart 1 shows house price inflation for the whole country, Auckland and ex-Auckland. The vertical lines show when each of the three LTV measures were announced. The general lesson is that the LTV measures had a significant but temporary impact on house price inflation. The initial measure in Oct 2013 saw the housing market ease for about a year before the underlying pressures came through again, particularly in Auckland and particularly in the investment sector.

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6. In this regard, the new-build exemption might not be appropriate in a situation of over-supply of housing.

Auckland house prices increased 24% in the year to April 2015 and the share of Auckland house sales going to investors had increased to 41%, up 8% from 2013. Meanwhile house price inflation in the rest of the country remained in low single figures. The stark regional differences and political realities made it very difficult to consider tightening the LTVs on a national basis. Accordingly, the 2015 tightening focussed solely on Auckland investors. The impact of the 2015 measures saw Auckland house price inflation fall back quite quickly to the 10-15% range but some of the Auckland investor buying pressure was shifted to the rest of the country and by late 2016 house price inflation in the rest of the country was on a par with Auckland. This led to the third measure which broadened (and tightened) the Auckland investor LTV restriction to the whole country. The impact of the October 2016 measure, combined with other moderating factors, was substantial, reducing house price inflation to single figures by mid-2017 and keeping it there through 2018. It appears that the tougher LTVs, combined with other factors such as tax changes, restrictions on foreign buyers and increased requirements on landlords, turned investor sentiment around. This in turn has moderated the whole housing market.

**Chart 1. House Price Growth (Annual)**

With regard to the prudential impact, this was unambiguous with the LTV measures contributing to a persistent reduction of risk in bank balance sheets. As seen in Chart 2, the share of outstanding mortgages with an LTV greater than 80 percent has steadily trended down as a result of the LTV policy from 21 percent
in September 2013 to 7 percent in December 2017. While there was a coincident rise in the volume of loans with LTVs between 70-80% and an increase in debt to income ratios through the period\(^8\), there is no doubt that overall risk in bank mortgage books was substantially and sustainably reduced. Recent Reserve Bank estimates suggest that banks’ credit losses from a severe housing downturn could be reduced by around 20 percent, compared to pre-2013. Also, with larger equity buffers, fewer households would be under pressure to sell their house or cut back on consumption in such a downturn.

Considering the impact of the LTV policy on leakage, this has not been seen to any great extent, although this may be a function of the New Zealand context given that the banks dominate the New Zealand mortgage market. The share of new mortgages issued by non-banks increased from two percent in 2013 to around four percent in 2018, a significant increase from the non-banks’ perspective but relatively small from a system perspective. Unsecured personal lending has not expanded to any marked degree which may reflect the Bank’s clear message to banks that such avoidance practices would not be tolerated. Probably the greatest leakage channel has been through the “bank of mum and dad”, ie through intra-family lending with parents helping to fund their children’s mortgage deposits. However, this effect has not been measurable.

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\(^8\) The Bank took the view that a Debt to Income (DTI) restriction would be a useful addition to the macro-prudential toolkit. Potential modifications to the toolkit will be considered in the current Review.
A further noteworthy impact of the LTV policy has been on the behaviour of various stakeholders. The initial public response was generally negative with news headlines emphasising the adverse impact on prospective first home buyers. As time went on, however, the public became more accepting of the policy and its potential to make housing more affordable in the future. Certainly, there was broad acceptance of the tougher measures applied to investor lending.

The response of the banks to the LTV policy was also initially negative: “too hard to implement, too intrusive, credit is not the issue for housing, rather it is the lack of supply”. However, as time went on the banks took ownership of the LTVs and some are now reluctant to see the measures eased. My characterisation is that the large banks see the LTV risk containment as sensible for the industry and for the housing market. However, if let free, competition for market share could once again become the dominant force and start to push mortgage risk profiles up again.

The impact of LTVs and the Bank’s messaging on other arms of Government was subtle but I believe significant. Housing affordability was becoming a major political issue and there was considerable pressure on Government to act on taxation (to reduce the tax-favoured status of housing) and on the supply side (planning, resource management, consenting, infrastructure development). In announcing the LTV measures, the Bank called for other (non-credit) policies to address the overall housing issue. While there remains considerable scope for improvement in overall housing policy, the Government took some actions in support of the LTV initiative, such as the move in the 2015 budget to increase the tax impost on short term capital gains.

Another impact worth noting is on monetary policy. With the Bank’s Governors making final decisions on both macro-prudential and monetary policies, they were well aware of the need to allow for the effects of each policy on the other policy’s objectives. This was the practice followed: monetary policy took the existing LTVs as given in preparing forecasts and making interest rate decisions; and vice versa. Monetary policy remained cognisant of its secondary financial stability objective: Governors did not say “Macro-prudential is looking after housing risk so monetary policy can now just focus on price stability.” Monetary policy continued to be aware of the need to support the financial stability objective.

6. Lessons from the New Zealand Experience

There are several lessons from the New Zealand experience with macro-prudential policy that are relevant for the future of macro-prudential in New Zealand and also for other countries pursuing similar policies. These can be grouped into three areas.
The first and main lesson is to emphasise the policy’s prudential role over its stabilisation role. LTVs, and I suspect macro-prudential policy more generally, can reliably improve banking system resilience but have limited and variable capacity to influence asset price cycles. Unfortunately, the news media and many stakeholders tend to judge the success of macro-prudential policy by its impact on the cycle. Therefore, the Central Bank and other authorities need to continually emphasise the prudential objectives and achievements of the policy and be modest in their attempts to manage the cycle. They need to emphasise that macro-prudential policy cannot control the housing cycle. It can at best moderate the cycle. As a corollary, macro-prudential measures must be calibrated with their prudential purpose in mind. The requirement for a prudential rationale imposes a discipline and consistency on policy settings.

Second, it is important to establish a coherent and sustainable policy framework based on sound data and analysis. In New Zealand and in other countries, macro-prudential is a new and little-tested policy approach. To remain as a viable and accepted policy it needs to become an established and systematic framework, more like monetary policy. This means being established in legislation, with a strong governance structure, an operational infrastructure that is workable for the banks, and a supporting database and analytic capability to guide policy decisions. Also necessary for ongoing policy coherence, the macro-prudential team within the Central Bank must cooperate closely with the mainstream prudential regulatory team, whether it is located in the Central bank or elsewhere. The right and left hands of prudential policy must coordinate policy and be fully aware of what the other is doing.

Very much related to the second lesson, a sustainable macro-prudential policy requires a continuous effort to build public and stakeholder support for the policy. To underpin public acceptance of a policy that can involve politically difficult measures, there is a need to be very transparent and accountable. This implies a considerable communications effort involving speeches, financial stability reports and plain language messages to the public conveying the shape and purpose of the policy. Also, the Central Bank must be seen to be accountable for its macro-prudential actions, for example through regular parliamentary hearings, with acknowledgement of unintended consequences and how these will be managed going forward.

7. Conclusion

Macro-prudential policy has been a useful addition to New Zealand’s policy toolkit since its introduction in 2013 and has succeeded in improving the resilience of the financial system. While the policy has had variable success in moderating the housing cycle, it has sustainably improved the resilience of banks’ balance sheets to potential housing market shocks. While not always plain sailing, the policy has ultimately won support from the public, parliament and the banks.
The lessons from the New Zealand experience relate to both policy approach and policy infrastructure. The policy approach should be modest in ambition and emphasise prudential goals over stabilisation goals. For macro-prudential to become an established mainstream policy, the policy infrastructure needs to be fully embedded in legislation with a sound governance regime. The choice of instruments and their application needs to be made systematic and predictable. And for ongoing public acceptance, the policy process needs to be transparent and supported by accountability structures.

Macro-prudential is a very new policy that has helped to fill an important policy gap. Careful management and governance will be required to ensure its ongoing success.
Consolidated Supervision and Anti-Money Laundering Compliance: The Crossroads of Effective Banking Supervision

By Gary Gegenheimer

Introduction

Increasingly, financial institutions are parts of wider groups. Banks are often affiliated with other kinds of financial businesses – insurance companies, securities firms, financial leasing companies and so forth – under the same corporate umbrella. In some cases, financial and non-financial businesses are combined into a “mixed-activity” group or conglomerate. Financial supervisors have recognized the necessity and benefits of “consolidated supervision” of such groups. In essence, consolidated supervision entails evaluation and analysis of the risks in any corporate group that contains a bank. In the broadest terms, supervision is “consolidated” when the banking supervisory body has the necessary legal tools to assess these risks, and to take action necessary to mitigate those risks that may prove harmful to a bank.

Traditionally, consolidated supervision has focused on “mainstream” items such as capital adequacy of the group, exposures of the group to third parties, and intra-group transactions that could pose problems for the bank or banks in the group. In recent years, however, financial sector regulators have come to realize that effective anti-money laundering and counter-financing of terrorism (AML/CFT) regimes must focus on group where an entity that is subject to AML/CFT requirements is part of a group. This is especially true in the case of financial groups, which will almost always have a number of such entities. This is simply an extension of the fact that banking supervision and AML compliance are complementary items: the better the quality of a country’s financial supervision, the less likely it is to have money laundering or terrorist financing problems.

This article will provide a brief look at the connection between traditional group supervision and AML/CFT compliance, and will offer some suggestions for financial regulators and boards of directors and management of regulated entities. This article focuses on groups that contain banks. However, the same principles can apply to any financial conglomerate or any other group that contains a regulated financial entity that is subject to prudential supervision, such as insurance companies or investment firms.

1. In some jurisdictions, other bodies, such as a financial intelligence unit (FIU), may have primary responsibility for AML/CFT compliance. In such cases, the banking supervisor should closely coordinate and cooperate with the FIU to achieve the goals discussed here.
Overview of Consolidated Supervision

Because of the dangers that group membership can pose to a bank, financial sector regulatory authorities must be aware of the structure of, and risks inherent in, any group of companies that includes a bank. Specifically, the regulator needs to be aware of the ownership structure, actual control, corporate governance standards, internal controls and risk management systems that the group uses to carry out its activities. The regulator also needs to review and assess the group’s controls on intra-group transactions and have continuing knowledge of aggregated large risk exposures within the group. The regulator further needs to assess the adequacy of capital on a consolidated basis to prevent a single financial entity within the group from showing an adequate capital position through the use of accounting “gimmicks.”

In order to accomplish these tasks, the regulator must have two critical legal authorities:

1. the authority to obtain reliable information about all of the entities in the group; and

2. the authority to take effective corrective actions, or cause other financial sector supervisors to do so, when activities or conditions of these affiliated persons may be detrimental to the financial stability of the bank(s) within the group.

It is important to note that consolidated supervision goes beyond accounting consolidation. A common misperception is that consolidated supervision and consolidated accounting are the same thing. They are not. The purpose of consolidated accounting is to present a full, fair and accurate picture of the financial situation of a group of companies. While this is one part of consolidated supervision, it is only one part. Consolidated supervision, a broader concept, focuses on group-wide risk management and the ability of the financial supervisor to require the group – typically through the ultimate parent holding company – to manage and control its risks.

Risks to Banks in Groups

All banks are subject to financial risks, which emanate from activities that they directly undertake. Traditional banking risks include credit risk, liquidity risk, interest rate risk, and foreign exchange risk. But special risks, which are not as easily measured, also become applicable if the bank is part of a “group” of companies. Some of these risks have direct applicability in the anti-money laundering context. Specific risks that apply in the group setting include the following:2

Contagion – the risk that financial difficulties in an affiliated company of a bank might “infect” the bank itself. Normally this arises when the bank’s depositors assume that financial problems of the affiliated company could mean that the financial stability of the bank is also in jeopardy. This perception can precipitate substantial rapid withdrawals of deposits, resulting in a liquidity deficiency, and, if the problem escalates, a major “run” on deposits, which can even spread to other banks.

In the AML/CFT context, if one member of a group is perceived by members of the public as facilitating criminal activity, it could negatively impact the reputation of other members of the group, which in turn can cause those other members to lose business.

Group Transparency – the possibility that a group’s controlling persons may deliberately choose a complex structure in order to obscure the group’s true ownership, control, or operations, and thereby avoid effective supervision of the bank. Financial groups frequently have very complex structures, which can make the implementation of group-wide policies difficult. Lines of accountability within the group must be clearly communicated and thoroughly understood by all personnel within the group who are responsible for legal and regulatory compliance. Supervisors need to thoroughly understand the group structure, the group-wide internal controls and how the group manages its risks. If this is not done, financial fraud and criminal activity, including money laundering and terrorist financing, are high possibilities.

Quality of Management – the risk that management or controlling persons of a non-bank parent company might establish policies for the group that are detrimental to the banks in the group. This can come about because the parent company might have business objectives other than prudent management of the bank, or lack a good understanding of the banking business and its regulatory requirements. In these circumstances, group/parent management might override or direct bank decisions, so that bank management loses some autonomy, or cannot exercise effective control over the bank’s lending or investment decisions. In the worst-case scenario, the managers or controllers of the group might see the bank as a “piggy-bank” – a cheap funding source for the other group members, with insufficient regard for the safe operation of the bank. As with the previous point, in this scenario insider abuse and bank failure are high possibilities. For this reason, bank supervisors need to be able to vet the “fitness and propriety” of controlling persons, senior management officials and members of the board of directors of any company that can control or significantly influence a bank.
In the AML/CFT context, if the parent company’s management fails to understand AML/CFT compliance issues and its board does not adopt effective group-wide policies, the AML compliance of the subsidiary institutions can be compromised. Bank supervisors need to be confident that the controlling persons and managers of ultimate parent companies clearly understand these issues, and that the bank’s AML/CFT risk assessment takes this into consideration.

**Group Exposures to Third Parties** – the possibility that individual lending limits could be circumvented through the use of bank subsidiaries. Unless these subsidiaries are included in the parent bank’s large exposure calculations, regulatory limitations on large exposures are easy to evade. This is also a concern in the wider group (e.g., a bank holding company and its nonbank subsidiaries) though it is usually not practical to apply the same kinds of “bank” lending limitations to such wider groups, especially if they contain a mix of financial and non-financial entities. However, such groups should be expected to develop effective policies and procedures to monitor and control exposures by group members to the same counterparty, or group of related counterparties.

Banks engage in many different forms of lending: real estate, trade finance, cash-secured loans, consumer, commercial, and agricultural lending, and credit card programs. Lending activities can include multiple parties in addition to the actual borrower, such as guarantors or signatories.

The involvement of multiple parties may increase the risk of money laundering or terrorist financing when the source and use of the funds are not transparent. This lack of transparency can create opportunities in any of the three stages of money laundering or terrorist financing schemes (placement, layering, and integration). Examples of such schemes could include the following:

- To secure a loan, an individual may purchase a certificate of deposit with illicit funds.
- Loans made for an ambiguous or illegitimate purpose.
- Loans are made for the benefit of, or paid for, a third party.
- The bank or the customer attempts to sever or obscure the paper trail between the borrower and the illicit funds.
- Loans are extended to persons located outside the bank’s home country, particularly to those in higher-risk jurisdictions and geographic locations, or may involve collateral property located in such jurisdictions.
One of the main dangers of weak AML/CFT controls is the possibility of credit losses through exposures to fictitious companies. Criminals often create shell companies through which to obtain financing to facilitate the laundering of their illegally-obtained proceeds with no intention of repaying the loans, leaving the lending bank with a portfolio of uncollectible credits. The negative effects of this activity can multiply if banks and their subsidiaries extend loans to the same fictitious company or group of related fictitious companies.

Concentration risk is the potential for loss resulting from too much credit exposure to one client or group of connected clients. Lack of knowledge about a particular customer, or who is behind the customer, or that customer’s relationship to other customers, can increase the risk to a lending institution. This is especially true where many borrowers are connected through informal relationships but share a common source of income or assets for repayment. Credit losses can also result from unenforceable contracts or contracts made with fictitious persons, both of which are high possibilities when dealing with persons involved in money laundering, terrorist financing or proliferation financing.

Because of these risks in the lending area, banks need to have policies, procedures, and processes to monitor, identify, and report unusual and suspicious activities, both within the bank itself and in its subsidiaries that conduct lending activities. There need to be procedures in place to identify borrowers that are connected through “control” relationships – regardless of the amount of formal ownership between the companies – or through a “common enterprise” so that the source of repayment is the same for a number of nominally unconnected borrowers.

♦ **Access to information** – the possibility that related non-bank companies of a bank may be unwilling or unable to supply information to the bank for onward transmission to the supervisor. Virtually all bank supervisory authorities have the legal power to obtain prudential information, such as financial data, transactional information, and governance policies and procedures about institutions that they directly regulate. Often this power extends to subsidiaries of the regulated institution. What is not always so common is the ability to obtain similar information from other members of the group, such as parent and sister companies, other controlling persons of the bank and entities controlled by them. In some cases, bank supervisors are limited to obtaining information from regulated banks themselves, and sometimes from their subsidiaries, but do not have similar authority relative to the broader group. This can be a particular problem in the case of foreign parents or subsidiaries, since legal powers to obtain information may have no validity in foreign jurisdictions. Without this ability, the bank supervisor cannot get a complete and accurate picture of the risks facing the group as a whole.
In the AML context, bank supervisors need to have confidence that they will be able to obtain relevant information from all members of the group, if necessary. This ability is just as important in the AML compliance area as in other areas such as intra-group transactions, large exposures and capital adequacy.

♦ **Moral Hazard** – the risk that related companies of a bank might take excessive risks in the belief that supervisory authorities will provide them with support to avoid a “contagion” effect on the related bank. Typically this arises in the context of lending or investment activity, but it is easy to see how it could apply in the AML/CFT context as well. If a company in a group has weak AML/CFT controls and this becomes known to the public, the contagion effect on the bank can be considerable.

**The Nexus between Consolidated Supervision and the Fight Against Money Laundering**

The connection between consolidated supervision and money laundering is perhaps best illustrated by the 1990s case involving Bank of Credit and Commerce International (BCCI), also known informally as the “bank of crooks and criminals international.” BCCI was a large international banking group with a parent holding company registered in Luxembourg, with numerous subsidiaries and branches in many countries all over the world. Ostensibly a financial institution, BCCI was in fact a conduit for all sorts of criminal activity. The “bank” assisted corrupt dictators in looting their countries’ treasuries, and did brisk business with terrorists, and drug traffickers. The owners and controlling persons of the bank purposely organized the group in a complex and confusing manner to avoid domestic and foreign supervision and regulation. When the bank finally collapsed in 1991, bank supervisors around the globe became determined to reconsider their focus and mission statements. Bank regulatory structures had traditionally been designed to facilitate supervision of stand-alone banks by individual regulatory bodies. The BCCI case made it painfully clear that focusing on individual banks in individual countries was no longer enough. As a result, the concepts of home-country and host-country supervisors and the concept of consolidated supervision arose. In the years following the BCCI collapse, bank regulatory authorities have increasingly entered into mutual assistance agreements and memorandums of understanding (MOUs) with their foreign counterparts, allowing for the exchange of supervisory information. The concept of consolidated supervision has become one of the most important topics in recent times, relative to the financial sector.
FATF Recommendations

The Financial Action Task Force, in its 2012 updates to its AML Recommendations, addresses the issue of AML/CFT controls in financial groups. FATF Recommendation No. 18 notes:

“Financial groups should be required to implement groupwide programmes against money laundering and terrorist financing, including policies and procedures for sharing information within the group for AML/CFT purposes. (FATF Recommendation No. 18)

“Financial institutions should be required to ensure that their foreign branches and majority-owned subsidiaries apply AML/CFT measures consistent with the home country requirements implementing the FATF Recommendations through the financial groups’ programmes against money laundering and terrorist financing.”

Similarly, Recommendation No. 26 provides:

“Countries should ensure that financial institutions are subject to adequate regulation and supervision and are effectively implementing the FATF Recommendations. Competent authorities or financial supervisors should take the necessary legal or regulatory measures to prevent criminals or their associates from holding, or being the beneficial owner of, a significant or controlling interest, or holding a management function in, a financial institution. Countries should not approve the establishment, or continued operation, of shell banks.

“For financial institutions subject to the Core Principles,3 the regulatory and supervisory measures that apply for prudential purposes, and which are also relevant to money laundering and terrorist financing, should apply in a similar manner for AML/CFT purposes. This should include applying consolidated group supervision for AML/CFT purposes.”

The message from FATF is clear: financial supervisory authorities need to apply AML/CFT risk management principles to financial groups. The question is exactly how to go about this.

3. Core Principles, in the FATF Recommendations, refers to the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision, the Objectives and Principles for Securities Regulation issued by the International Organization of Securities Commissions, and the Insurance Supervisory Principles issued by the International Association of Insurance Supervisors.
Creating a Legal Framework for AML Compliance in the Group Context

The first step in creating an effective legal framework for AML compliance at the group level is to identify the “group.” For present purposes, we shall focus mainly on financial groups. FATF defines a “financial group” as:

“a group that consists of a parent company or of any other type of legal person exercising control and coordinating functions over the rest of the group for the application of group supervision under the Core Principles, together with branches and/or subsidiaries that are subject to AML/CFT policies and procedures at the group level.” [emphasis added]

What is striking about this definition is that in order to have a “financial group,” there must first be a “group.” However, FATF does not specifically define a “group.” In bank supervisory parlance, there are three basic kinds of groups:

(1) the bank and its subsidiaries, sometimes called a simple banking group, or just a banking group.

(2) a financial conglomerate, a group of companies that engage in a range of different financial activities that have been traditionally kept separate (typically defined as banking, securities underwriting and/or trading, and insurance);

(3) a mixed-activity group, which contains commercial and industrial companies as well as one or more banks or financial institutions.

The precise parameters of a group can vary between jurisdictions, and between international bodies (such as the European Union). However, certain common themes can be observed. The “group” should include any legal entity that “controls” a bank; any entity that the bank “controls,” and any entity that is under common control with the bank (“sister” or “affiliated” companies).

Obviously, a critical aspect of group identification is a good “control” definition. “Control” should be clearly but broadly defined. It should contain a specific numerical threshold. 50% is common in international practice, but some countries, such as the United States, use lower thresholds, such as 25%. The definition should specifically encompass both direct and indirect ownership, in order to pick up control through a chain of ownership, such as a string of subsidiaries. It should also include a more subjective element such as “controlling influence” or “dominant influence” to pick up those situations where a person can exercise real control over the bank with little or no formal share ownership. If a 50% numerical threshold for “control” is used, a country might wish to also include other companies over which the bank or the ultimate parent company of
the group can exert considerable influence, but not actual control. For example, under many European Union directives, a “group” includes not only parent and subsidiary companies, but also companies in which the ultimate parent or any of its subsidiaries holds a “participation,” generally defined as direct or indirect ownership of at least 20%.

The FATF recommendations refer to the obligations of an institution to apply AML/CFT risk management principles to its overseas branches and wholly-owned subsidiaries. However, the FATF principles also note that AML/CFT compliance needs to be enforced by financial supervisors at the “group” level, without limiting this concept to parents and wholly-owned subsidiaries. As a practical matter, legal compliance needs to be enforced relative to any company that a bank or its parent holding company can “control” (regardless of whether such control results from majority ownership, being the largest shareholder albeit less than a majority, or merely through exercise of a dominant influence through informal means). As any seasoned bank supervisor is aware, actual control is much more relevant than formal ownership. To put it another way, the obligation to apply AML/CFT prevention measures to a bank and its majority-owned subsidiaries is a necessary – but not sufficient – component of an effective AML/CFT regime.

Legal Powers of the Supervisory Authorities

Once “control” is defined and the “group” is identified, the next step is to ensure that the supervisor has adequate tools as described above – that is, the power to review and approve all controlling persons, board members and senior management officials of any parent company of the bank; the power to require all members of the group (particularly the ultimate parent company) to provide relevant information to the supervisor; and the authority to require appropriate corrective action if necessary. The supervisory authority should also have the legal power to approve the ownership structure of the group, including the major shareholders and management officials of the parent company.

All of these items have strong applicability in the context of AML/CFT compliance. Virtually all bank supervisory bodies have the authority to approve the composition of the ownership and controlling persons of banks, both at the licensing stage and whenever there is to be a change in control or significant ownership/influence over the bank. Part of the regulatory inquiry should include examination of the impact of the licensing decision or acquisition on the bank’s AML compliance function. If the bank is to be a subsidiary of another company, the inquiry should entail an analysis and evaluation of the ultimate parent’s AML/CFT policies, including how the parent monitors AML/CFT compliance by its subsidiaries (and if applicable and to the extent feasible, by other companies within its group over which it can wield a significant influence). This task is easiest if
the parent company is a regulated financial entity that is subject to AML/CFT requirements in its home country. If the decision-making supervisory authority will also be the supervisor of the parent company, it should use its supervisory powers to insist on high-quality AML/CFT procedures at the parent level, to include group-wide policies and procedures. If the parent is regulated and supervised by another financial regulatory body, the decision-maker should closely coordinate and cooperate with that body. This will normally consist of obtaining information from the other regulatory body about the quality of the parent’s AML/CFT regime. If the other regulatory body is located in a foreign country, this task will be more difficult, but still should be undertaken. Countries should ensure that mechanisms exist for the exchange of information between regulatory bodies that have AML/CFT jurisdiction, so that financial regulators can confidently evaluate the AML/CFT policies of proposed foreign acquirer of control or significant influence over their domestic financial institutions.

If the proposed acquirer is not an entity that is subject to AML/CFT compliance requirements, this task is more difficult, but it is not insurmountable. This issue could arise, for example, in the case of a mixed activity group, where the ultimate parent company may be an unregulated entity (a chain of grocery stores, an industrial company, etc.) or simply a non-operating holding company that controls a wide range of financial and non-financial businesses. Because these entities may not themselves be subject to AML/CFT compliance, they may not have existing AML/CFT policies and procedures to evaluate. However, the analysis and evaluation should still take account of AML/CFT compliance issues. While it may not be feasible to require the acquiring entity to implement a full-blown AML/CFT compliance program for itself and its group, it is eminently reasonable to insist that the acquirer ensure that at least the regulated entities in the group have acceptable AML/CFT compliance programs. Banking laws often contain provisions whereby the supervisory authority can approve proposed acquisitions subject to conditions that are not expressly enumerated in the approval criteria, but that are deemed to be necessary for the protection of the bank or its depositors.

**Post-acquisition Issues: Examination Authority**

The Basel Committee notes that a bank’s Customer Due Diligence management program, on a group-wide basis, has should have the following essential elements:

(a) a customer acceptance policy that identifies business relationships that the bank will not accept based on identified risks;

(b) a customer identification, verification and due diligence program on an ongoing basis, which encompasses verification of beneficial ownership, based reviews to ensure that records are updated and relevant;
(c) policies and processes to monitor and recognize unusual or potentially suspicious transactions;

(d) enhanced due diligence on high-risk accounts (e.g., escalation to the bank’s senior management level of decisions on entering into business relationships with these accounts or maintaining such relationships when an existing relationship becomes high-risk);

(e) enhanced due diligence on politically exposed persons (including, among other things, escalation to the bank’s senior management level of decisions on entering into business relationships with these persons); and

(f) clear rules on what records must be kept on CDD and individual transactions and their retention period, which should be at least five years.

Bank regulators have the ability to conduct examinations of banks. If their country has a good consolidated supervision regime, the regulatory body will also have the legal authority to conduct examinations of parent companies of banks and other members of the group (sometimes this authority is limited to banks and their subsidiaries, which is problematic). With regard to other group members that are regulated non-bank financial institutions, this function can often be coordinated with other financial sector regulators in order to avoid overlap and duplication. Particularly with regard to the ultimate parent company of a group, examination procedures should include a review and evaluation of the quality of the AML/CFT regime at the group level, to ensure that the parent is effectively overseeing AML/CFT compliance for the entire group.

**Post-acquisition Issues: Enforcement Issues**

An important aspect of consolidated supervision is the ability of the bank supervisor to take enforcement action, or cause other financial supervisory bodies to do so, if violations of unsafe/unsound practices are discovered during the course of the supervisory process. An effective consolidated supervision regime authorizes the bank supervisor to issue corrective orders against bank holding companies, controlling persons, and in many cases other group members, if the financial condition or activities of those other companies could adversely affect the bank or banks in the group. This process should extend to AML/CFT compliance. Weak or ineffective AML/CFT compliance programs at the group or parent level could negatively impact any bank in the group, as a result of contagion or the possible misuse of the bank by the controlling persons. In the event that deficiencies are detected at the parent level, the supervisory authority should require the parent company to improve the group AML/CFT compliance program.
A common legislative provision in banking laws is the ability to impose fines for violations. Such provisions are useful and necessary, but are not sufficient by themselves to achieve corrective action. The Basel Core Principles contains the following advice in its “Essential Criteria” for compliance with Principle 11 (Corrective and sanctioning powers of supervisors):

The supervisor raises supervisory concerns with the bank’s management or, where appropriate, the bank’s Board, at an early stage, and requires that these concerns be addressed in a timely manner. Where the supervisor requires the bank to take significant corrective actions, these are addressed in a written document to the bank’s Board. The supervisor requires the bank to submit regular written progress reports and checks that corrective actions are completed satisfactorily. The supervisor follows through conclusively and in a timely manner on matters that are identified.

A good analogy is the “Prompt Corrective Action” regime in the United States, which is used in cases of capital-deficient banks. If a bank’s capital falls below a certain prescribed threshold, the bank is required to develop and implement a capital restoration plan satisfactory to the bank supervisor, with specific targets and methods of how they will be achieved. The bank is required to submit periodic progress reports to the bank supervisor, and if the goals of the plan are not achieved or if the bank’s capital declines further, additional provisions may be added to the plan.

The same logic should apply to correction of deficient AML/CFT policies and procedures. This should apply at both the individual bank level and at the level of the group, through action directed at the ultimate parent company, if applicable.

**Governance Aspects of Group-wide AML/CFT Compliance**

While bank supervisors or AML compliance authorities can do a great deal to foster AML/CFT compliance in their countries, the ultimate responsibility for safe and sound operation of a bank – including AML/CFT matters – rests with the bank’s board of directors.

Specifically, in the AML/CFT context, the board is responsible for approving the bank’s AML/CFT program, overseeing the implementation of that program by the bank’s AML/CFT compliance function and senior management, receiving reports from management and the bank’s internal audit function, and reviewing the program periodically and ensuring that it is updated as necessary, and ensuring that any deficiencies are addressed in a satisfactory manner.

When a bank is a subsidiary of another company, however, the parent company’s board is responsible for the entire group. The parent company should have policies in place to prevent practices that could jeopardize the subsidiary banks or the consolidated organization. A fundamental principle of the bank holding...
company/bank subsidiary relationship is that the holding company should serve as a source of financial and managerial strength to its subsidiary bank(s). In the AML/CFT context, the key word is “managerial.” The holding company board must ensure that its subsidiary institutions that are subject to AML/CFT requirements are developing and implementing effective AML/CFT programs.

The rationale for this policy is that in acquiring a commercial bank, a parent company derives certain benefits at the corporate level that result, in part, from the ownership of an institution that holds enormous amounts of other people’s money (deposits) and has access to central bank credit. The deposit aspect is heightened if a country offers deposit insurance. The existence of these governmental “safety nets” reflects an important public policy determination regarding the critical role of depository institutions in the country’s economy as repositories of depositors’ funds, operators of the payments system, and impartial providers of credit. Said differently, in return for obtaining the advantages that stem from ownership of a commercial bank, bank holding companies have an obligation to serve as a source of strength and support to their subsidiary banks. This goes beyond providing financial support when needed, and extends to ensuring that the banks are operated safely and soundly, and do not wittingly or unwittingly become conduits for aiding criminals.

The parent company should therefore maintain AML/CFT policies for itself and its subsidiaries that provide guidance and controls in all key areas. The existence and wording of these policies, the degree to which the policies are followed by the subsidiaries, and the effectiveness of the policies in controlling risk to the entire organization are all matters of which the parent’s board needs to be keenly aware. Management and the board of the parent company should periodically interact with the board and management of each subsidiary company to discuss and review the group’s and subsidiary’s AML/CFT policies.

There is no particular best format for this purpose. Much will depend on the characteristics and specific lines of business of the members of the group, the size of the group, whether the group operates in foreign countries or purely domestically, and so forth. The important thing is that the parent company’s board is aware of the AML/CFT programs in any of the company’s subsidiaries that are subject to AML/CFT requirements; that these programs are being implemented effectively; and that the group as a whole (including any non-regulated entities that may not themselves be subject to the full panoply of AML/CFT requirements) is operated in a manner that does not leave the group vulnerable to criminal activities.

Each regulated entity in the group should of course have its own AML/CFT policies and procedures, but the ultimate parent company of the group should have responsibility for overall group compliance. This can be accomplished by having the

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board of directors designate an AML/CFT Compliance Officer at the parent company level, and to mandate that this person’s responsibilities would be to coordinate the group’s AML/CFT policies to ensure consistency. This may require a certain amount of flexibility, since the specific procedures may differ depending on the precise nature of the business. There should also be a requirement for all regulated entities of the group to provide reports to the parent’s AML/CFT compliance function, including reports of suspicious transaction reports and currency transaction reports filed with the country’s financial intelligence unit or equivalent body. The parent company’s internal audit function should also review the effectiveness of the parent’s AML/CFT compliance function, including the effectiveness of its oversight of the AML/CFT programs of the other companies in the group.

This does not mean that the bank’s own board is off the hook. The primary duty of a bank’s board is to ensure the bank operates in a safe and sound manner. In the case of a bank that is a subsidiary of a holding company, the bank’s board must ensure that relationships between the bank and the other group members do not pose safety and soundness issues for the bank and are appropriately managed. Specifically, the bank’s board should carefully review the parent company’s policies that affect the bank, including AML/CFT policies, and ensure that those policies are adequate for the bank. If the bank’s board is concerned that the holding company is engaging in practices that may be detrimental to the bank, or that the company’s AML/CFT policies are inadequate or ineffective, the bank’s board should notify the holding company’s board and seek to bring about changes, if possible. If the holding company board does not address these concerns, the bank directors should dissent on the record and consider actions to protect the bank. This may entail hiring independent legal counsel, accounting experts or other consultants. The bank’s board also may also wish to raise its concerns with the supervisory authority or financial intelligence unit.

Conclusion

Effective AML/CFT compliance cannot be achieved in a bank that is part of a group, unless it is implemented at the level of the group. By only focusing on the policies and procedures of the bank itself, bank supervisors or financial intelligence units may miss money laundering risks to the bank that could emanate from the bank’s relationships with other members of the group. Giving high priority to AML/CFT issues as part of the supervisory mission – whether these are addressed mainly by the prudential supervisory authority itself or by the financial intelligence unit acting in cooperation with the prudential supervisor – will greatly enhance the overall quality of the supervisory function and the integrity of the financial system. To reiterate a point made earlier, the better the quality of a country’s financial supervision, the less likely it is to have problems in the money laundering and terrorist financing areas.