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The Enemy Within – Internal Threats to the Stability and Integrity of Financial Institutions

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Access to and Use of Information in the Supervision of Financial Groups

Cheong-Ann Png, Counsel, Asian Development Bank

As a former student of Professor Barry Rider who used to help out at the Symposium, I am honoured and proud to be back and amongst colleagues and friends many of whom are real experts in economic crime. I can only hope to contribute a thought or two to our discussions in this excellent forum.

A key element of the recent financial crisis is the systemic impact of large financial groups on the financial sector and national economies. The collapse of Lehman Brothers in September 2008 brought inter-bank lending to a standstill, crippling businesses and financial activities around the world. Liquidity problems and eventual receivership of 3 out of 4 major banks in Iceland, whose consolidated assets expanded from 100% of the GDP in 2004 to 900% of the GDP in 2007, caused its economy to collapse and necessitated short-term financing from the IMF, culminating in a standby arrangement of SDR1.4 billion.

Unlike the Asian financial crisis of the 1990s, whose impact was largely on the emerging markets, this financial crisis affected most major economies.

At the same time, financial scandals continue to hit the headlines. In particular, the Stanford Financial Group was able to sell financial products in the US without being regulated through the use of a US business linked with the Stanford Investment Bank which is regulated in Antigua. Although not quite the same scale as the operations of and illegitimate activities associated with the BCCI, nonetheless, it reminded us of pertinent issues in the supervision of financial groups with cross-border operations. (I should of course be careful when making references to the BCCI as I am on the same panel as the man who helped bring it down.) And such issues are invariably accentuated in the case of larger and more complex financial groups such as Citibank and AIG.

Central to these developments are the questions of whether they could have been averted had these financial groups (and more generally, financial sector activities around the world) been better regulated and supervised, and if so, how.

This was part of the agenda of the G20 summit in Washington DC in November 2008 which culminated in the establishment of 4 working groups to examine issues relating to strengthening transparency and accountability, enhancing sound regulation, promoting integrity in the financial markets, reinforcing international cooperation and promoting the reforms of international financial institutions. The reports of these working groups were finalised in March 2009 and implementation of their recommendations currently underway.

In parallel were changes to national regulatory approaches, such as in the US, as well as prominent studies like the work of the High-Level Group on Financial Supervision in the EU led by Jacques de Larosiere which published its report in February 2009. Colleagues at the IMF have spent a lot of time on related matters. Some leaders also talked about how the international financial architecture ought to be revamped.

In this respect, it may be worthwhile to go back to basics and consider some of the key elements of consolidated supervision of banking groups whereby all risks of a banking group should be taken into account wherever their activities are physically located. Here, the Basel Core Principles (as articulated in the Basel Core Principles Methodology 2006) offer a useful starting position. For today, may I highlight the following 5 elements:

- Supervisors should have the power to review the overall activities of a banking group, both domestic and cross-border.
- Supervisors should have a supervisory framework that evaluates the risks that non-banking activities conducted by a banking group may pose to the group.
- Supervisors should have arrangements with other relevant supervisors for sharing information on the financial condition and risk management controls of the banking group. This includes home-country and host-country supervisors sharing information in a timely manner. Particularly where:
 - There is material or persistent non-compliance with prudential regulation requirements, such as capital ratios or operational limits.
 - There are adverse assessments of the qualitative aspects of a banking group's operations, such as risk management and control.
 - There are adverse or potentially adverse developments in the foreign operations of a banking group.

- Supervisors should raise concerns with the management or where appropriate, the board, of the banking group and require concerns to be addressed in a timely manner, including taking of corrective actions.
- Supervisors should have powers to impose limitations on or even require closing of a foreign office of a banking group if it determines that supervision by the host-country supervisor is not adequate relative to the risks the office presents or if it cannot gain access to the information required for supervision on a consolidated basis.

At the practical level, effective consolidated supervision depends on a range of factors and it may be appropriate to mention 3 of them.

First, access to reliable information and data on a timely basis is key. Whether in the form of international supervisory colleges as recommended by, and established pursuant to, the work of the G20 working group for all (some 25) systemically important global financial institutions. Or through formal or informal bilateral arrangements between supervisors. Such information and data should of course remain confidential and be applied as appropriate.

Whichever way the regulatory architecture is designed and applied to large financial groups, may I suggest that such access to information and data remains essential. Moreover, information sharing whether at the national level, or on a cross-border basis, is not straightforward at the best of times. Indeed, different interests and priorities, not to mention procedural requirements, often impact on information sharing in more precarious situations.

This financial crisis brought forth an additional consideration - the systemic impact of distressed large financial institutions on the economy. In this respect, financial regulators/supervisors, especially where they are independent of the central banks, should appreciate the macro-economic significance and potential impact of the activities of major financial groups. An example is the recent reforms in the US where the Obama Administration announced in June 2009 that the Federal Reserve will be authorised to monitor major financial institutions (thus broadening its role in monetary policy). This includes the power to supervise and ultimately intervene in distressed financial institutions.

Second and conversely, the notion of “wilful blindness” as sometimes discussed in the context of the supervision of the BCCI group continues to be a concern where there is lack of clarity in the responsibilities of home-country supervisors and host-country supervisors. Or in the more extreme cases, some supervisors simply looked away when there are prudential regulatory concerns or even fraud and money laundering. As in the case of the recent events relating to the fraudulent activities of the Stanford Financial Group, where allegations have been made against the supervisor in Antigua with respect to the Stanford Investment Bank which it regulates and

that has businesses in the US which carried out the multi-billion dollar ponzi scam of the Stanford Financial Group.

Third is implementation. Whether in the form of ensuring that supervisors have adequate resources to carry out their activities or having suitable bilateral or other arrangements in place to facilitate information sharing and cooperation. Or ensuring that supervisors have a suitable range of measures to address supervisory concerns, whether in the form of compelling information disclosure or participation in resolution of distressed banks. Or perhaps more importantly, the political will and institutional efforts to follow through implementation, particularly when financial markets are buoyant.

In this respect, as ADB's activities are targeted at our developing member countries, it is worth mentioning that a recent survey by a former senior ADB official on central banks and financial supervisors in the Caucasus, Central Asia and South Asia suggested that almost all of them recognised the need to move towards risk-based and consolidated supervision. Moreover, a number of them have established, or are in the process of establishing, suitable procedures and processes. That said, effective implementation remains the key change. Not least where it is complicated in countries where there is more than one financial regulator/supervisor and given the capacity limitation in developing countries.

There is obviously more to be said on this topic but as it is already past tea-time on a Saturday, I should stop for the time being and thank Professor Rider for the very kind invitation to speak at the Symposium as well as to everyone for your attention.