



TECHNICAL

NOTES & MANUALS

Resolving Opaque Bank Ownership and Related-Party Exposures

Edda Rós Karlsdóttir, Rachid Awad, Ender Emre, Alessandro Gullo,
Aldona Jociene, and Constant Verkoren

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This note intends to provide advice to bank supervision and resolution authorities and policymakers seeking to deal with opaque bank ownership or significant overhang of related-party exposures.¹

The note addresses the following issues:

- Discusses how international standards aim to ensure effective oversight of bank ownership structures and related-party transactions, and prudent management of the ensuing risks to the banks' viability and financial integrity.
- Discusses opaque bank ownership structures and excessive related-party exposures and transactions, and the risks they pose to financial stability when they reach systemic proportions.
- Discusses how these can be addressed in the context of a comprehensive financial sector restructuring strategy that aims to discover and remediate the root causes of banking sector problems.
- Illustrates a diagnostic framework that has proven useful in identifying banks' beneficial owners and related-party exposures and transactions.
- Discusses possible mechanisms to remove nontransparent or unsuitable shareholders and how to unwind excessive related-party exposures of systemic proportions.
- Touches upon the treatment of bank owners and other related parties in resolution.

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¹ Country references in this note are based on authors' own understanding of the relevant domestic legal framework. Such references should not be treated as the authorities' official interpretation.

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Abbreviations

AML/CFT	Anti-money laundering/combating the financing of terrorism
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
FATF	Financial Action Task Force
G20	Group of Twenty, Forum for International Economic Cooperation
IMF	International Monetary Fund
OECD	Organisation for Economic Co-operation and Development

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I. Introduction

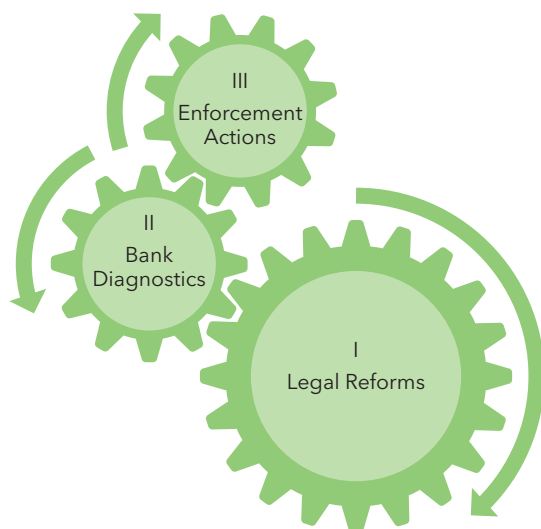
Opaque and otherwise unsuitable bank ownership presents risks to financial integrity and stability. Such ownership structures are often associated with poor governance, anti-money laundering (AML)/combating the financing of terrorism (CFT) violations, tax evasion, and other fraudulent activities, and can hamper effective prudential supervision of related-party transactions. Lack of information and transparency about the natural persons who ultimately own or control banks,¹ makes the banks susceptible to excessive risks and misuse. Opacity in a bank ownership structure hampers the reliable identification of a bank's beneficial owners, the assessment of its owners' suitability, the verification of (the quality of) banks' capital, and the timely identification of all related parties. Moreover, unknown owners cannot be held accountable for the emergence of problems attributable to their actions (for example, embezzlement) or inactions (for example, insufficient controls).

Similarly, excessive related-party transactions present a major risk to financial stability. These transactions are highly exposed to conflict-of-interest risks and have the potential to be unfair, abusive, and even fraudulent, which happens when such transactions are undertaken on preferential terms, or when they serve to further the personal interests of parties related to the bank. Such transactions often go unreported, concealing the nature and extent of the risks being undertaken. As a result, related-party transactions can lead to bank failures and are often associated with weaknesses in bank governance, credit discipline, and risk management. Related-party exposures can also increase banks' losses and potential resolution costs (including to the Deposit Insurance System) because of reduced asset recoveries. They could also threaten financial stability when these risks affect systemic banks, or when they reach excessive levels and are propagated across the financial sector.

The risks arising from related-party exposures and opaque ownership structures are well recognized in international standards. In particular, the Basel Core Principles for Effective Banking Supervision (BCP) (BCP 2012), the Group of Twenty (G20)/Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance (OECD 2023), and the International Financial Reporting Standards aim to ensure transparent disclosure and monitoring of bank owners and related parties, as well as prudent management of the ensuing risks to banks' solvency and viability (IFRS 2023). In addition, the AML/CFT standards set by the Financial Action Task Force (FATF) provide detailed measures that, among others, seek to prevent criminals and associates from being the beneficial owners of financial institutions, or otherwise utilizing them for illicit purposes.

Yet, opaque ownership and abuse of bank resources by related parties may still arise and reach levels that threaten the stability of individual banks and the financial system. This can be attributed to various reasons, including legal and regulatory frameworks that are not aligned with international standards, gaps in broader legal and institutional infrastructure (for example, judicial system and company registries),

¹ In this note, the term "bank owner(s)" or "ownership" refers to those who control the bank and those who hold an interest, subject to supervisory approval. This term includes the beneficial ownership of the respective controlling interest or significant interest. It is not dependent on formal ownership, and it includes any direct or indirect holdings, alone or jointly with others (for example, shareholder agreements). With "changes in ownership" or its derivatives, the intention is to capture changes that are significant; that is, which affect bank owner(s) or ownership as discussed (that is, including the beneficial owners) and, thus, subject to prior supervisory approval. The terms beneficial owner and ultimate beneficial owner are used interchangeably in the literature, with the former used by the Financial Action Task Force (FATF) and the Organisation for Economic Co-operation and Development (OECD) and the latter by the Basel Core Principles for Effective Banking Supervision (BCP) (BCP 2012). This note uses the term beneficial owner. Moreover, the BCP requires that the supervisor identify a bank's major shareholders, including the beneficial owners and others who may exert significant influence. Although the BCP does not define these terms, when it uses "major shareholders," this note intends to refer to controlling shareholders. For those others who may exert significant influence, the paper uses the term "significant shareholders."

Figure 1. The Three-Pillar Approach

Source: IMF staff.

supervisory failures, or corruption vulnerabilities. Although aligning the legal and regulatory frameworks to international standards is a necessary condition to address underlying risks, a comprehensive approach is needed when opaque bank ownership and related-party problems are widespread in the banking sector, and their systemic nature could threaten financial stability. Some of these vulnerabilities are more acute in developing economies; however, problems in beneficial owner and related-party identification may be pervasive across a broad spectrum of jurisdictions, including advanced economies.

This note illustrates a three-pillar approach (Figure 1) for addressing opaque bank ownership structures and related-party exposures of systemic proportions. It is difficult to set a predefined quantitative threshold to determine whether and when these issues are of systemic proportions. Instead,

such assessment will be based on a holistic evaluation of various considerations, particularly based on safety and soundness concerns. The approach in this note envisages legal reforms (Pillar I) that lay the foundation for targeted bank diagnostics (Pillar II) and effective enforcement actions (Pillar III). Although the presented diagnostics phase draws on experiences in two country cases (Moldova, Ukraine), it may offer a useful example for countries facing similar challenges elsewhere. The three-pillar approach followed in both areas (beneficial owners and related parties) can have some common elements.

- *Legal reforms* align domestic primary and secondary legislation with international standards for transparent reporting and monitoring of bank owners, related parties, and their transactions, whereas curbing jurisdiction-specific business structures and practices used to conceal bank ownership and related-party transactions. Where needed, reforms would also seek to support enforcement efforts by enhancing the role of supervisory judgment and providing for escalating enforcement measures.
- *Bank diagnostics* of relationships and transactions are conducted to identify related parties or banks' beneficial owners using predefined indicators of legal, managerial, operational, and economic relationships. These indicators also help identify or reveal concerted actions between multiple persons (including related parties and beneficial owners) to control a bank, which may otherwise appear independent of each other, thus allowing for better targeted enforcement actions. Country-specific circumstances may not always call for parallel identification processes for related parties and beneficial owners. However, targeting both through comprehensive diagnostics can be mutually reinforcing.
- *Enforcement actions* are needed to address noncompliance with the requirements on bank ownership and transactions with related parties. These aim to, immediately, preclude unidentified and otherwise unsuitable beneficial owners from corporate decision making and curtail their economic rights, and, ultimately, remove them from ownership structures and unwind excessive or irregular related-party transactions under a timebound plan. These actions can be complemented by other corrective measures, such as pecuniary sanctions or measures concerning the bank's operations, management, and board. Ultimately, resolution or liquidation actions may be needed.

Resolving unsuitable bank ownership and excessive related-party exposures may take considerable time, particularly in systemic cases. The process can be complex and time-consuming, depending on the state of the legal and supervisory framework at the outset, the supervisory resources applied, the supervisor's independence from political or industry interference, and the rule of law. In addition, the resolution of related-party transactions must consider the size and nature of the transactions, the banks' initial capital position, and broader financial stability considerations. Against this backdrop, it is desirable to prepare a timebound project plan for the design and implementation of necessary actions. In the event of a crisis involving opaque ownership and suspected excessive related-party exposures, the authorities will need to contain the crisis and apply their early intervention and resolution/liquidation framework, possibly by making any targeted legal changes that can be feasibly made under exigent circumstances. Subsequent actions may include the application of this three-pillar approach at a systemwide level, while pursuing all legally available avenues to hold accountable those responsible for the failure, to address moral hazard and reestablish market discipline.

Addressing systemic issues of opaque beneficial owner and related-party exposures is best done in the context of a comprehensive financial sector restructuring strategy. Viable banks for which material shortcomings are identified (and their shareholders) should be instructed to pursue remedial actions, whereas banks unable to implement these actions—or otherwise deemed nonviable—should be placed in resolution or liquidation. In case of (suspected) illicit activities, the supervisor should promptly notify law enforcement agencies and share any relevant information in its possession. The identification of banks' beneficial owners, and other related parties in failed banks, supports the integrity of the financial system (for example, by preventing unsuitable shareholders from controlling banks and conducting other financial sector activities in the future). Forensic audits may prove indispensable to fostering accountability of those persons and aid asset recoveries.

The measures recommended in this note can be flexibly implemented on a modular basis as appropriate to country circumstances. For example, the legal reform and enforcement pillars could be more relevant than the diagnostics pillar, where bank owners and related parties are already known but concerns relate to the suitability of these owners and excessive related-party exposures. Similarly, the need for upfront legislative reforms would diminish where an initial gap analysis suggests that the legal framework on bank ownership and related-party transactions is already broadly in line with good practices, whereas jurisdiction-specific legal changes may be needed once a diagnostic reveals the shortcomings that need to be addressed. Jurisdictions should assess whether the three-pillar approach needs to be pursued fully or partially, and, if so, with what modifications. This note touches on some areas (such as the removal of unsuitable shareholders and the treatment of related parties in resolution) that are not elaborated under international standards and could inform the action of authorities when beneficial owner opacity and related-party exposures affect banks' soundness, even in the absence of a systemic effect.

Although the proposed measures on opaque ownership and excessive related-party exposures may reinforce each other, they can be implemented separately. Bank owners constitute a key component of related parties. Hence, the identification of beneficial owners can inform actions to detect and address excessive related-party exposures. Conversely, various legal, operational, managerial, and financial indicators developed to diagnose related-party transactions can provide input to the supervisory authority, while identifying concerted actions or the joint holding of voting rights. Furthermore, some issues discussed in this note, such as resolution treatment, can be relevant to both bank owners and other related parties. It is because of these potential connections, as shown also in country experiences of Moldova and Ukraine, that there is merit in analyzing ownership issues and related parties together in this note. However, the opacity of beneficial owner should be addressed on its own, even when it is not linked with the breach of related-party

exposure limits. By the same token, related-party abuses could be a concern, even in the presence of a clear picture of bank ownership.

Strong political support, supervisory independence, and adequate resourcing are key preconditions to address beneficial owner and related-party exposures of systemic proportions. Country authorities should adopt and publicly announce a policy of ownership transparency and suitability, and of compliance with prudential limits on related-party transactions within the context of effective and intrusive bank supervision.² Adherence to international standards and good practices on operational independence of the supervisor and sound (supervisory) governance is also key to ensuring that the supervisor can fulfill its mandate without political and industry interference, and is free from conflicts of interest. Legal protections for the supervisor, its staff, and agents against lawsuits for actions taken in good faith should also be strengthened. Financial autonomy of the supervisor is important to ensure the (potentially significant) resources needed to implement the measures recommended in this note.

² In countries with governance problems, pervasive corruption, and the lack of rule of law, this new policy will need to be repeatedly communicated throughout the process of implementation. This could help shield the supervisor from persistent political and industry interference and speed up the process of policy implementation.

II. Ownership Transparency and Suitability

Good Practice in Bank Ownership Transparency and Suitability

The suitability of owners is key to ensuring the proper functioning of banks. The lack of accurate and timely information on beneficial ownership can veil the identity of known or suspected criminals, the true purpose of a bank's activities, and the source of its financial resources. Moreover, opaque ownership can undermine effective corporate governance (because of the risk of conflicts of interest and potential abuse in the bank's products and services), jeopardize its financial soundness, and undermine confidence in the institution (Office of the Comptroller of the Currency 1988). These risks can lead to banking problems and, when not dealt with early and effectively by bank supervisors, it can fuel bank failures. Therefore, an effective regulatory and supervisory framework should aim to ensure transparent ownership structures and prevent unsuitable persons from directly or indirectly acquiring control or significant interest in banks,³ both at the bank licensing stage and continuously thereafter.

Because of the risks of opaque and otherwise unsuitable ownership structures, standard setters have long sought to provide guidance on their identification and suitability. Two main international standards set requirements that apply throughout the various stages of a bank's life, starting with their licensing. Both require an assessment of the suitability of bank owners and of the fitness and propriety of banks' board members and senior management.

- *The BCP* are the minimum standards for sound prudential regulation and supervision of banks and banking systems. They require the bank licensing authority to set licensing criteria and reject applications that do not meet these criteria. This process should include a thorough assessment of the (proposed) bank ownership structure and governance, as well as its strategic and operating plan, internal controls, risk management, and proposed financial structure (including its capitalization). The supervisor should require that the criteria for issuing licenses be consistent with those applied in ongoing supervision.
- *The FATF recommendations* provide a comprehensive and consistent AML/CFT framework to combat money laundering and financing of terrorism risks (FATF 2014 and 2023). Among others, they require competent authorities to take the necessary legal or regulatory measures to prevent criminals and their associates from holding, or being the beneficial owner of, a significant or controlling interest in a financial institution. To this end, bank owners (and managers) should be assessed against fit-and-proper requirements.⁴ The FATF requirements rely, among others, on the general FATF definition of beneficial ownership of legal persons and arrangements (Box 1).

³ Controlling interest refers to the holding by a person directly or indirectly of the majority of ownership interests or voting rights in the bank, or to the ability to elect, appoint, or remove a material number or majority of the members of the governing body of a bank, or otherwise to exert dominant influence in a bank's policies and strategic decisions (for example, the decisions on dividend distributions). Significant interest refers to the holding by a person directly or indirectly of a minimum ownership interest or voting rights as prescribed in the law, or to the ability to appoint at least one member of the governing body of a bank, or otherwise to exert "significant influence" over the bank's policies and strategic decisions. Laws or regulations may further provide for the indicators of control and significant influence to inform the application of these concepts. Control and significant interest could be exercised by the person alone or together with other shareholders by the means of contract (such as shareholder agreement), understanding, relationship, intermediary, or tiered entity.

⁴ FATF Recommendation 26: Regulation and supervision of financial institutions.

BOX 1. Beneficial Ownership

Transparency of the beneficial ownership of legal persons (for example, companies) and of legal arrangements (for example, trusts) is a concept well established under the international standard on AML/CFT. The concept is relevant also for other standards, for example, the BCP, and the OECD Global Forum on tax transparency.

In the FATF recommendations, a beneficial owner refers to the natural person(s) who ultimately own(s) or control(s) a customer. It also includes those persons who exercise ultimate effective control over a legal person or arrangement, including any that exercise any form of (in)direct control without any formal ownership.

Only a natural person can be a beneficial owner, and more than one natural person can be the beneficial owner of a given legal person or arrangement. Pursuant to FATF requirements, every legal person should know their beneficial owner(s). See discussion in the main text.

International standards require every legal person (including those that are banks) to know who their beneficial owners are, and to have this information ready and up to date, including for sharing with competent authorities (which includes supervisors and regulators). The sharing of beneficial owner information can therefore be done promptly, and with little or no administrative costs to the legal person. The inability or unwillingness to do so should raise red flags and likely prompt the supervisory authority to not issue a license. For more information, see also Berkhout and Fernando (2022).

Source: FATF 2023.

According to the BCP, adequate oversight and regulation of a bank's ownership should include the following requirements and powers.⁵

- The evaluation of the suitability of the bank's (proposed) major shareholders and other individuals who may exert significant influence (that is, those who are to hold a controlling or significant interest) is determined as part of the licensing process and day-to-day supervision. The evaluation includes, among others, an assessment of the (proposed) owner's reputation, integrity, and financial soundness, with the latter focusing on the sources of funds used to acquire the shares, and the owner's ability to provide additional financial support where needed.⁶ Where the proposed owner or parent organization is a foreign bank, the prior consent of its home supervisor is obtained. Transparency of the bank's ownership structure, and its wider group, is assessed to ensure that it will not hinder effective supervision on both solo and consolidated bases. The licensing authority also determines, where appropriate, that these structures do not hinder the effective implementation of corrective measures in the future.
- The need to obtain supervisory approval or provide immediate notification of proposed changes in bank ownership, including beneficial ownership, or changes in the exercise of voting rights above a certain threshold, based on quantitative and qualitative indicators. In line with this requirement, many jurisdictions typically specify in laws and regulations the various situations and thresholds based on which supervisory notification or approval is needed (Box 2). Supervisory processes elaborate on how these criteria and thresholds are monitored and enforced.

⁵ BCP 5 on licensing criteria, BCP 6 on transfer of significant ownership, and BCP 7 on major acquisitions.

⁶ For country examples, see European Central Bank (2021) and the US Federal Deposit Insurance Act, section 7(j) on change in control of insured depository institutions.

BOX 2. Requirements and Thresholds for Changes in Banks' Ownership Structures: Selected Country Cases

Various jurisdictions set requirements and thresholds based on quantitative and qualitative indicators to approve (or require notification of) significant changes in ownership structure. Based on the Bank Regulation and Supervision Survey, published by the World Bank in 2019, all but 7 of the 160 surveyed jurisdictions have the power to refuse approval of beneficial owners when assessing bank ownership (World Bank 2019).

The threshold to define *controlling* or *significant interests* varies across jurisdictions. Most jurisdictions require prior approval (or notification with the right to object by the supervisor) for different thresholds and types of ownership interests. The following are some examples:

- The European Union defines a qualifying holding in an institution as a direct or indirect holding representing 10 percent or more of the voting rights, or making it possible to exercise a significant influence over the management of the institution. Advance notification to the National Competent Authorities is needed for natural and legal persons wishing to acquire, directly or indirectly, a qualifying holding in a credit institution, or to further increase, directly or indirectly, such a qualifying holding to 20, 30, or 50 percent of the voting rights, or of the capital held or so that the credit institution would become its subsidiary. The National Competent Authority may decide to oppose the acquisition. In the absence of persons with qualifying holdings, supervisors will instead generally focus on the 20 largest shareholders.
- In the United States, federal statutes and their implementing regulations define controlling interest but not significant ownership. "Control" for this purpose is defined as "the power, directly or indirectly, to direct the management or policies of an insured depository institution or to vote 25 percent or more of any class of voting securities of an insured depository institution." Under limited circumstances, a presumption of control arises when a person would own, control, or hold the power to vote 10 percent or more of any class of voting securities. Prior authorization by the appropriate federal banking agencies is required for any person to acquire "control" of a bank. A "person" includes an individual, a group of individuals acting in concert, or certain entities (for example, corporations, partnerships, and trusts) that own shares of banks, but that do not qualify as bank holding companies.
- In Brazil, the corporate law defines a controlling shareholder as the individual, legal entity, or group of people joined by voting agreement or group of legal entities under common control (control group), which (1) hold voting rights that assure the majority of votes in the decisions of the general shareholders' meeting and the power to appoint the company's senior management, and (2) use that power effectively to direct corporate activities. In addition, qualified ownership is defined as the direct or indirect participation by individuals or legal entities, equivalent to 15 percent or more of the shares or representative quotas of the total capital of a financial institution. Authorization of the Central Bank of Brazil is needed for proposed participation equal to or greater than 15 percent in a financial institution. There is a notification requirement to the Central Bank of Brazil in respect of changes of voting or nonvoting capital above 5 percent.
- Some jurisdictions (for example, Serbia, Tanzania, and Vietnam) have set a 5 percent threshold for significant ownership. A lower threshold allows more control by supervisors of banks' owners and may be an effective tool to deal with legacy problems with governance and opaque ownership structures. It is also good practice to require prior supervisory approval when an existing holding exceeds certain higher thresholds, based on the voting rights or capital of an institution (for example, Angola and Türkiye).

- Supervisory powers to reject, or impose prudential conditions on, any proposal for a change in bank ownership, or to prevent the exercise of voting rights in respect of relevant acquisitions, to ensure that any such ownership change meets criteria comparable to those used for licensing banks.
- Supervisory powers to revoke a bank's license or to reject, modify, or reverse changes in bank ownership, if they were based on false information.
- Supervisory powers to take appropriate action to modify, reverse, or otherwise address a change in control that has taken place without the necessary notification to, or approval from, the supervisor.
- Banks' periodic reporting about the identity and holdings of all significant bank shareholders, including those of beneficial owners of shares held by nominees, custodians, or through vehicles where beneficial ownership may be disguised.
- Banks' obligation to notify the supervisor immediately about any material information that may negatively affect the suitability of a major shareholder or a party that has a controlling interest.

The FATF recommendations urge countries to ensure adequate, accurate, and up-to-date information on the beneficial ownership of, and control over, legal persons as well as legal arrangements. A multipronged approach is mandated for effective identification of the beneficial owners of legal persons to ensure efficient and timely access to beneficial owner information by competent authorities, reflecting underlying risks, context, and materiality.⁷ The FATF recommendations identify three sources of information that countries should include, as set out in the following. For the purposes of fit-and-proper assessments, authorities should rely on the first source for the initial information, and on the second and third to verify the information:

- *Company source:* Companies (including those that are banks) should be required to obtain and hold adequate, accurate, and up-to-date information on their own beneficial owner(s) and to cooperate with competent authorities to the fullest extent possible in determining the suitability of the beneficial owner(s), including by making relevant information available to the competent authorities in a timely manner. The inability or unwillingness to share beneficial owner information should raise red flags that may preclude the issuance of a bank license (or result in its revocation) (Berkhout and Fernando 2022).
- *Registry or alternative mechanism source:* Beneficial ownership information of legal persons should also be held by a public authority or body (such as a tax authority, financial intelligence unit, company registry, or beneficial ownership registry). Other alternative mechanisms are also permitted under the FATF recommendations, if they provide authorities with efficient access to adequate, accurate, and up-to-date beneficial ownership information.
- *Additional supplementary sources:* Additional supplementary measures should also be used, as necessary, to ensure that the beneficial ownership of a company can be determined. This can include, for example, beneficial ownership information held by regulators or stock exchanges, or obtained by financial institutions or designated nonfinancial businesses and professions (for example, trust and service company providers) in accordance with their customer due diligence obligations (identification of their customer's beneficial owner).

Supervisors should regularly monitor banks' ownership structures and beneficial owners and respond promptly to any problems identified. Such monitoring is achieved by establishing regular reporting and immediate notification/approval requirements about significant changes in a bank's ownership. These tools should be designed to identify not only banks' direct shareholders but also indirect shareholders and beneficial owners. Any problems identified should be promptly addressed, for example, by preventing the exercise of voting rights or requiring divestitures in cases where a change of ownership/control has taken place without the necessary supervisory approvals.

⁷ FATF Recommendation 24: transparency and beneficial ownership of legal persons.

It is good practice to require public disclosure of a bank's beneficial owners. It is essential that banks report their beneficial owners to the supervisor. Supervisors should verify the accuracy of these reports, including by way of information sharing with local and foreign authorities, and other information sources (including but not limited to centralized registers and databases). Moreover, the legitimate interests of other stakeholders justify the disclosure of beneficial owners to the public more broadly.⁸ The G20/OECD Principles of Corporate Governance (OECD 2023) already recommend the disclosure of such information as a material issue relevant to investors and to contribute to accountability.⁹ The International Organization of Securities Commissions "Objectives and Principles of Securities Regulation" (IOSCO 2017a and 2017b) also suggest that information about persons holding a significant interest and seeking a company's control be disclosed, including with beneficial owners. For banks, enhanced transparency is warranted even more, because banks enjoy exclusive rights to collect deposits from the public and their soundness can be affected by the suitability, including the financial strength, of their beneficial owners. To that end, the Basel Committee on Banking Supervision (BCBS) Corporate Governance Principles for banks indicate that banks should apply the disclosure and transparency section of the OECD principles, including on major share ownership (BCBS 2015, principle 12). Notwithstanding these standards, OECD (2022) identified the lack of appropriate disclosure on group structure and beneficial owners as a pressing issue. The 2019 World Bank "Bank Regulation and Supervision Survey" showed that more than half of the surveyed jurisdictions across advanced, emerging market, and developing economies did not yet require public disclosure of banks' beneficial owners (World Bank 2019).

Addressing Systemic Problems with Opacity in Bank Ownership

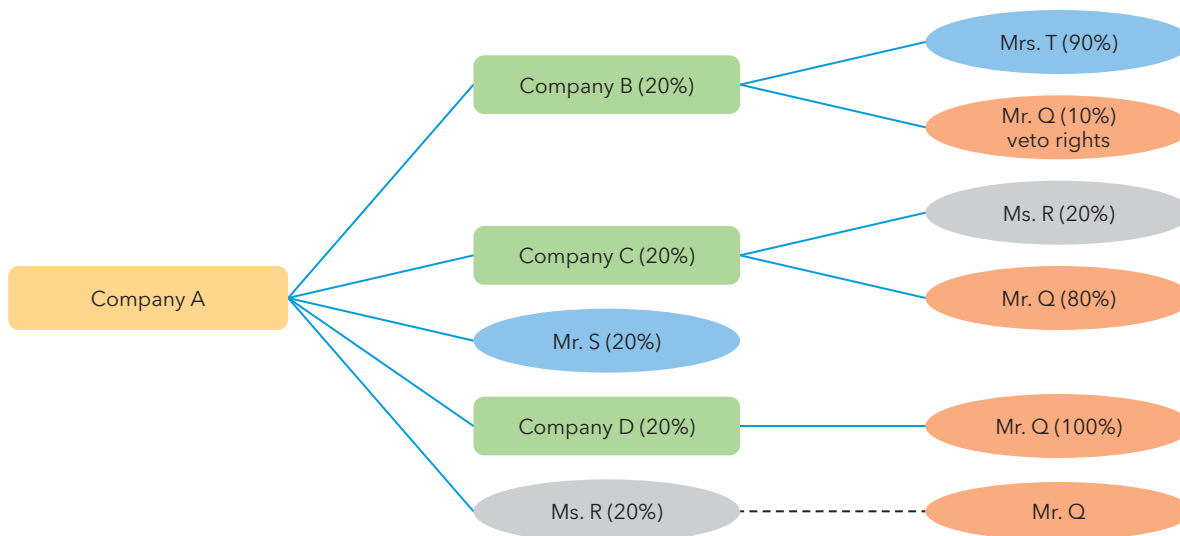
Weak supervisory oversight and enforcement can result in systemwide opaque and otherwise unsuitable bank ownership.¹⁰ Common characteristics of opaque ownership structures include (1) excessive layers of ownership (for example, chains of holding companies), often complicated by crossholdings between legal entities; (2) owners' residency in foreign jurisdictions that do not support effective cross-border cooperation on supervision and AML/CFT matters; and (3) complex usage of available legal persons and arrangements (for example, special purpose vehicles, trusts) aiming to separate legal and beneficial ownership. Although nontransparent shareholder structures typically use a chain of legal entities to create a corporate veil (Figure 2), this is not always the case. A bank may have multiple nominal shareholders with relatively small equity holdings each ("strawmen") that act in concert to gain control in the interest of an undisclosed beneficial owner.

Mapping of the legal persons operating in a country is needed to inform legal reforms. Berkhout and Fernando (2022) provide guidance on such mapping. They also offer examples of how various domestic and foreign-created legal persons can be misused to veil (unsuitable) ownership and facilitate crime, how the associated AML/CFT vulnerabilities and risk can be assessed, and how mitigation measures can be designed. In jurisdictions where opaque bank ownership is pervasive, the bank supervisor may be aware of

⁸ To address any privacy concerns, consideration should be given to offering tiered access to the registers and databases to relevant stakeholders, based on need-to-know principles. For example, the general public might be given access to the name and country of residence of a beneficial owner (Berkhout and Fernando 2022).

⁹ G20/OECD Principles of Corporate Governance (OECD 2023), Section IV, requires that "the corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company." It is further elaborated that ownership-related information should also cover beneficial ownership.

¹⁰ Moldova, for example, suffered a major fraud in the banking system in 2014, stemming from opaque bank shareholder structures and related-party transactions. In its aftermath, three banks were resolved at a public cost of 10 percent of GDP, external concessional financing was largely frozen, international reserves fell by one-third, and monetary conditions had to be tightened significantly. See IMF 2016.

Figure 2. Ownership Structures: A Stylized Example

The ownership interests in Company A are as follows:

- Mrs. T has 18 percent (she owns 90 percent Company B, which owns 20 percent of Company A).
- Ms. R has 24 percent (she directly owns 20 percent of Company A, as well as owning 20 percent of Company C, which owns 20 percent of Company A).
- Mr. S directly owns 20 percent of Company A.
- Mr. Q owns 38 percent (he owns 100 percent of Company D, which owns 20 percent of Company A; 80 percent of Company C, which owns 20 percent of Company A; and 10 percent of Company B, which owns 20 percent of Company A). Based on this, Mr. Q is the largest beneficial owner of Company A. In addition, if the control structure of Company A was further examined, beyond ownership interest, Mr. Q holds veto rights for decision-making processes in Company B, even though he only owns 10 percent of this company, and he also indirectly controls Ms. R (who happens to be his daughter and a nominee shareholder). This means that Mr. Q directly and indirectly controls 62 percent of the banks' shares or voting powers.

Source: Berkhout and Fernando 2022.

legal structures utilized to veil ownership—and possibly also the beneficial owners behind the veil—but may lack policy mandate and legal powers to mitigate the ensuing risk.

Pillar I: Strengthening the Legal and Regulatory Framework

The three-pillar approach first seeks to ensure that the legal framework for bank ownership can effectively support beneficial owner identification. To achieve this, three types of legal amendments may be needed. First, amendments may be needed to bring the framework in line with international best practices for designating beneficial owners. Second, country-specific amendments may be needed to facilitate the identification of beneficial owners, and to strengthen mechanisms to combat the misuse of legal persons, dealing more specifically with the opaque ownership structures prevalent in the country.¹¹ Third, amendments may be needed to address weaknesses of the broader framework or public infrastructure that contributed to the establishment or maintenance of opaque ownership structures, including disclosure requirements or (the absence of) public registries.

¹¹ As mentioned in the introduction, these specific legal amendments may also be introduced in conjunction with the diagnostics phase, because they provide authorities with targeted powers to detect and remove the idiosyncratic ownership structure emerging in such phase.

Common examples of failures to implement BCP standards and FATF recommendations related to bank ownership include the following:

- *Underlying definitions:* A common problem relates to narrow or unclear definitions of “group,” “controlling interest,” and “significant ownership,” or other relevant terms; for example, exclusively based on quantitative indicators such as ownership thresholds. Definitions may fail to capture voting rights being exercised without legal ownership (for example, under a collateral arrangement) or preferential voting rights (for example, veto rights). To address such problems, qualitative indicators should also determine control (for example, de facto control or dominant influence)¹² and significant ownership (for example, significant influence). In ascertaining beneficial owners, jurisdictions should give consideration to direct and indirect holdings, concerted actions, and agreements that affect voting rights (for example, shareholder agreements).
- *Licensing framework:* Gaps may manifest as an incomplete list of licensing requirements, such as in relation to the suitability of significant shareholders, transparency of ownership structure, and absence of any situation that hinders effective supervision. Even where shareholder suitability is required, the substantive criteria for assessing such suitability may be weak (for example, focusing on business reputation only, and not on financial strength), or not extend far enough (for example, exclude indirect shareholders with significant influence over the bank). Further, the burden of proving suitability may not be placed sufficiently with the applicant, boxing the authorities into pro forma checks of basic requirements (for example, on nonconviction and education) and forcing positive decisions.
- *Framework for the transfer of significant ownership or control:* Gaps typically preclude effective enforcement of licensing requirements on an ongoing basis; for example, where the law inadequately defines the transactions that require supervisory approval or notification and lacks the necessary powers to respond to transactions that took place without such approval or notification.
- *Reporting requirements:* Although banks may be required to report regularly on their ownership structures, the reports may not sufficiently capture the entire ownership chain and the nature of relationships between the entities that make up the chain. Moreover, the reports may not cover shareholder agreements or any other arrangement that affects the exercise of voting rights.¹³

Additional legal amendments, beyond international standards, may need to be considered to provide the powers and tools to address jurisdiction-specific circumstances. In addition to aligning the framework to international standards, further enhancements may detail the powers or criteria provided in the law, set forth more stringent requirements, or provide the authorities with explicit legal basis to take discretionary action aimed at unveiling country-specific beneficial owner schemes. Where such discretion does not already flow from the broader administrative law or banking law, examples of enhancements include (1) restricting the complexity of bank ownership, for example, by limiting the number of ownership layers; (2) lowering the threshold for direct and indirect “significant ownership,” to enable the supervisor to deal with opaque ownership structures and concerted actions that were designed to keep the relative share of individual shareholders just below preexisting regulatory thresholds (Box 3);¹⁴ (3) requiring banks’ bylaws to stipulate

¹² “De facto control” focuses on influence, rather than on quantitative criteria. Canada’s Office of the Superintendent of Financial Institutions (2009) provides a robust concept of “control in fact.”

¹³ Significant shareholders may be required to not only report whether they have entered into agreements, but also to disclose to the regulator and the public a description of the main provisions set forth under such agreements. Chile, for example, specifies the circumstances in which a shareholder agreement is deemed to exist and to be reported (for example, if a foreign shareholder cannot be properly identified).

¹⁴ A very low threshold for requiring supervisory approval for bank ownership comes at a cost, for example, in the form of additional resources needed at supervisor/licensing authority, and less flexibility in capital markets. Such measures may also induce shareholders to further act in concert while keeping their shareholding levels below the limits.

BOX 3. Identifying Nontransparent Bank Ownership Structures in Ukraine

As part of its efforts to deal with nontransparent ownership, the National Bank of Ukraine identified six commonly used indicators of nontransparent ownership in 2015:

- *Footballers*: Distributing shares among 11 people in order to avoid the breach of 10 percent qualifying holding threshold
- *Hugger-mugger*: Cyclical or multilevel ownership chains
- *Offshore special purpose vehicles*: Presence of nonresidents from specific jurisdictions in the ownership structure, who act as nominees
- *Who are these people?* Bank management pretends to not know the bank owners
- *Trust*: Presence of a discretionary trust in the ownership structures
- *Power of attorney*: Issuance of power of attorney and obtaining an exemption from the financial soundness assessment

The National Bank of Ukraine followed a three-pillar approach comprising legal reforms, diagnostics, and removal of unsuitable shareholders. The key features included:

- Any natural person who owns shares in a legal entity (including in the ownership structure of a bank) and any legal entity with participation of more than 2 percent on any level of an ownership chain of a legal entity were defined as “key participants in a legal entity.” For shareholder structures with more than 20 natural persons, the largest 20 individual shareholders were defined as “key participants.” In multilevel ownership chains, natural persons on the last level of the ownership chain were defined as “ultimate key participants.”
- If the National Bank of Ukraine had grounds to believe that a bank’s declared ownership structure was misreported, the relevant ultimate key participants were subject to a financial soundness assessment. The ultimate key participants had to prove their sources of wealth commensurate with their percentage of ownership in the regulatory capital of a bank. In addition to verifying the true ownership, this helped the National Bank of Ukraine assess the ability of the existing owners and potential investors to provide financial support to a bank in the future.
- If 2 out of 10 ultimate key participants with at least 5 percent combined ownership (or 1 ultimate key participant with at least 10 percent ownership) failed to pass the financial soundness assessment, the National Bank of Ukraine was empowered to recognize the bank ownership structure as “nontransparent” and to classify the bank as a problem bank. The banking law provides that a problem bank must align its activities with the applicable laws and regulations within 120 days, or else the National Bank of Ukraine shall declare the bank insolvent and turn it over to the Deposit Guarantee Fund for resolution.

This approach allowed the National Bank of Ukraine to identify the beneficial owners behind the banks’ qualifying holdings in the first four ownership structures presented here. To eliminate the two remaining nontransparent structures, the following measures were taken:

- The Discretionary Trust structure was legally defined as “nontransparent for prudential purposes”; and
- The simplified process for authorizing natural persons to act under a power of attorney was abolished, which effectively eliminated the “power of attorney” structure.

Following this process, some 50 banks were found to have up to 100 percent of shares held by undisclosed qualifying shareholders and were consequently defined as “problem banks.”

that full disclosure of beneficial ownership and adequate disclosure of any shareholders' agreements is a precondition for exercising their shareholder rights; (4) explicitly requiring additional disclosures, for example, by nominee directors and shareholders of their nominee status and the identity of their nominator to the bank and any relevant registry; (5) empowering the supervisor to require legal persons to sign affidavits to attest to the accuracy of provided information on legal ownership or control (statement of compliance);¹⁵ (6) explicitly empowering the supervisor to declare a specific ownership structure as "nontransparent" and, thus, in breach of licensing requirements; (7) explicitly stipulating in law that bank owners or shareholders from jurisdictions that are uncooperative for the purposes of prudential supervision, or are considered to have strategic AML/CFT deficiencies,¹⁶ do not meet suitability requirements; and (8) increasing monetary fines to incentivize shareholders to promptly rectify identified violations and deter further breaches.

Efforts to strengthen shareholder transparency may require improvements in the general legal and institutional framework governing ownership rights. The effectiveness of regulatory improvements depends heavily on the extent to which there is a legal framework that supports the provision of accurate information on bank (and all company) shareholders, and supports the identification of related parties, including through timely updates of company registers. To tackle opaque ownership structures comprehensively, weaknesses in the commercial registry system should be addressed. Improvements of the central securities depository system could also be useful to provide for centralized settlement and registration functions for corporate securities (for example, where ownership records of shares held at private share registries are vulnerable to fraud and abuse of data).

The legal framework needs to provide for a range of enforcement actions. Some supervisory tools prescribed in the BCP are necessary and normally sufficient, for example, suspension of shareholder rights and monetary fines, although their specifics may differ across countries (Box 4). However, the critical question is how to expel a controlling or significant shareholder from the bank if these tools are not sufficient (for example, in situations where opaque ownership persists or does not pass muster), and how to handle the bank in the interim—particularly when supervisory failures are pervasive and risks to financial stability are high. Although the BCP in general recommends a range of possible measures to address irregularities and unsafe and unsound practices, including license revocation, jurisdictions' approach in such cases will be determined by legal tradition, institutional setup, the regulatory and supervisory framework, resources and processes, and the overall efficiency and transparency of the court system. Boxes 4 and 5 describe tools and powers available in different jurisdictions under general rules. The authorities should consider their adequacy or the merit of any specific change when beneficial owner opacity affects the soundness of a bank or becomes systemic.

The legal framework should also provide for mechanisms to hold bank owners and managers accountable for leading a bank to failure through fraud, gross misconduct, and asset stripping. Such accountability is a key element of a strategy to restore confidence in the banking system, including by mitigating moral

¹⁵ Such affidavits or attestations can be helpful to the extent that the legal framework provides for appropriate accountability mechanisms (for example, dissuasive sanctions or liability) in case of false/misleading information.

¹⁶ The FATF continually identifies and reviews jurisdictions with strategic AML/CFT deficiencies that present a risk to the international financial system and closely monitors their progress. Periodically, it publishes a list of jurisdictions (sometimes referred to as a "gray list") with strategic weaknesses in their national AML/CTF regimes to counter money-laundering/financing of terrorism and proliferation financing that are actively working with the FATF. High-risk jurisdictions subject to a call for action (sometimes described as on a "black list"), on the other hand, are countries or jurisdictions with serious strategic deficiencies to counter money-laundering/financing of terrorism, and the FATF calls on all members to take varying degrees of action toward these countries (for example, to apply enhanced customer due diligence, or in extreme situations to take countermeasures to protect the financial system from the associated risks).

BOX 4. Preventing Unsuitable Shareholders from Exercising Governance-Related Rights

In line with the BCP, many jurisdictions empower the supervisory authority to eliminate the ability of unsuitable shareholders to influence the corporate decision-making process, as well as day-to-day management of the bank. The legal mechanisms through which this goal is pursued may differ across jurisdictions. Some jurisdictions provide for the suspension of these rights, whereas in other jurisdictions the exercise of these rights is transferred to another person or authority.

- *Suspension of governance-related rights:* These rights concern the shareholder's ability to take part in decision making at shareholders meetings (that is, to attend and vote in such meetings, including on matters related to the appointment of managers and dividends) and to gather information from the management. Suspension creates a strong incentive for the relevant shareholder to align its situation with shareholder requirements (for example, to seek supervisory approval) or to sell its shares. However, the suspension of governance-related rights may trigger new suitability assessments for other shareholders since these may then qualify as "controlling" or "significant" shareholders because of holding now a relatively higher percentage of the shares with voting powers. There is a risk that this newly created corporate balance may give rise to a deadlock in corporate decision making.
- *Transfer of governance-related rights:* This model prevents any potential deadlock in corporate decision making but can weaken confidence in the bank, and it should be considered a part of a broader strategy to address financial difficulties. It also requires a sound legal and institutional framework, including a clear mandate for the person or authority exercising such rights and the role of the supervisory agency in its appointment, and monitoring. In Germany, governance rights are transferred to a court-appointed trustee (Article 2c(2) of the German Banking Law) and in Ukraine, to a supervisor-appointed authorized person (Article 73 of the Ukrainian Banking Law).

In both models, the appointment of a temporary administrator (or a person with a similar title) may also be justified in some cases, as discussed in the main text.

hazard risk and aiding with asset recoveries.¹⁷ The responsibility of the owners (and other related parties) will need to be determined based on the jurisdiction's legal framework, which may consist of general rules (for example, fraud or tort liability) and specific dispositions. Mechanisms are discussed in the section titled "Related Party Identification and Risk Mitigation."

Regulations, supervisory procedures, and bank reporting forms should be enhanced in tandem with revisions to policy, powers, and tools. The following areas are particularly relevant: (1) procedures of the licensing and authorization function; (2) methodology and criteria for the identification of concerted actions; (3) rules for assessing ownership structure transparency, shareholder and beneficial owner suitability, fit-and-proper criteria for board members and other senior management, and procedures for their (re)assessment; (4) reporting forms for banks' ownership structures and disclosure (a key input for subsequent diagnostics); and (5) enforcement strategy and procedures. Publication of rules and procedures should be considered in order to clearly convey supervisory expectations and provide incentives to the banks and their shareholders to cooperate.

¹⁷ Moral hazard occurs when an agent increases risk without facing the full consequences, which in part or in full will be borne by another agent, such as a government bailing out the creditors of a failed bank.

BOX 5. Options for Removing Unsuitable Shareholders

Cross-country experiences point to various options for removing opaque and otherwise unsuitable shareholders. Although these actions will be informed by the broader legal framework—factoring in, for example, constitutional safeguards (for example, requiring compensation), company law, and securities law provisions—the authorities should be able to act quickly and transparently, while considering the depth of capital markets, efficiency of the judiciary, and the associated legal risks. Options available under legal frameworks include the following:

- *Invalidate acquisitions that occurred without supervisory approval:* In some jurisdictions, an acquisition that took place without supervisory approval can be declared null if the shareholder fails to dispose of their ownership within the determined timeframe (Serbia). Although feasible for newly acquired shares, this model is less feasible for acquisitions concluded several years earlier, as is typically the case with legacy opaque ownership structures.
- *Share cancellation:* This involves the cancellation of the relevant shares and the issuance of new shares for sale (Moldova, Romania). However, the process in this model could be cumbersome, and there is a risk at a later stage that unsold shares may be converted into treasury shares, which would negatively affect the bank's regulatory capital. This approach may also raise risks that are challenging to mitigate, including governance risk when the voting rights of remaining shareholders increase proportionally, and these may not be certified as suitable for holding larger stakes.
- *Supervisory order for sale through a commissioned trustee or administrator:* A trustee or administrator takes over the shareholder rights and arranges for the sale of the shares, subject to supervisory monitoring (Germany). To ensure effectiveness, the legal framework should clearly prescribe the administrator's minimum qualifications, mandate, duties, and powers vis-à-vis the bank and its shareholders, and provide for legal protection.
- *Court order for sale:* In common law jurisdictions (Jamaica, United Kingdom) and in some civil law jurisdictions (Belgium), the supervisory authority may apply to the court for a sale order. Although involvement of a court may have strong merits, it requires an efficient and transparent judiciary that is well equipped to handle the complex trade-offs between public and private interests.

Pillar II: Diagnostic Process

Beneficial Owner Identification and Suitability Assessment

Banks' reliable reporting on their shareholders represents a cornerstone for adequate beneficial owner identification and owners' suitability assessments by the supervisor. The process should cover all banks, except fully state-owned banks and potentially banks that are owned by foreign banking groups that have fully disclosed their beneficial owners to a cooperative home supervisor and are subject to effective consolidated supervision. In jurisdictions with many banks and limited supervisory capacity, the identification process can start with systemically important banks or those that present the highest vulnerabilities and risks, including money-laundering/financing of terrorism risks. The diagnostic process will typically entail (1) an analysis of ownership structures, including signs of potential nontransparency; (2) the identification of shareholders acting in concert without proper disclosure; (3) a suitability assessment of bank owners; and (4) an assessment of close ties between unsuitable shareholders and bank management, as a potential channel to influence day-to-day operations.

Banks' reported ownership structures are reviewed to determine whether these comply with the (new) prudential transparency requirements. Based on reforms introduced to the legal framework as described in

the previous section, banks will be required to report more detailed information to the supervisory authority about the natural persons and legal persons and arrangements within each ownership layer that leads to the beneficial owner—for example, legal ownership (shareholdings), other means of control (golden shares), and nominee arrangements. Insufficient reporting about the structure and the beneficial owner should be considered as a potential sign of nontransparency.¹⁸ As discussed, supervisory reporting should be complemented by public disclosure by banks of adequate information on their beneficial owners (see previous discussion).

A detailed investigation of suspected concerted activities may also be needed to determine significant influence or control. This is important for the application of thresholds for determining ownership or control, and to identify structures that were designed to sidestep regulatory limits. Many of the criteria used to identify a group of connected counterparties (as per the Basel standards on measuring and controlling large exposures), as well as the information acquired while identifying related-party transactions, could help detect concerted activities and, therefore, the beneficial owners.¹⁹ However, the considerations to detect whether persons are acting in concert could be much broader and entail additional factors and types of relationships (see footnote 18).

All beneficial owners of controlling or significant interests should be (re)assessed. In particular, the assessment should aim to verify that beneficial owners have no record of criminal activities or involvement in illicit activities or suspicious practices. It should also assess their financial soundness, that is, the sources of funds for the acquisition of bank shares and whether the beneficial owners have the ability to provide additional financial support to the bank, if needed. The financial soundness assessment is a key tool to identify potential “strawmen” (that is, nominal shareholders that lack financial strength and act in the interest of an undisclosed beneficial owner). In jurisdictions with legacy opaque shareholder structures of systemic proportions, this assessment may call for identified beneficial owners to submit audited financial statements, tax returns, bank account statements, independent personal asset valuations, and other documents. In addition, the supervisor should gather information from public sources and request information, subject to strict confidentiality requirements, from other authorities (domestic and foreign supervisory agencies, tax authorities, financial intelligence units, public agencies holding information about beneficial ownership). Interviews with bank management and identified beneficial owners could provide further insights on ownership structures and beneficial owner suitability and, more broadly, ensure transparency of the diagnostic process.

Pillar III: Enforcement

Acting on the Diagnostic Findings

Based on the diagnostic findings, banks should be required to bring their ownership structure in compliance with laws and regulations within a reasonable timeframe. Unsuitable shareholders should be immediately suspended from corporate decision making and from receiving dividends. Bank board members and senior managers should undergo recertification for fitness and propriety in case of reasonable doubt about their

¹⁸ For example, the joint guidelines by the European Union’s financial regulation authorities on the prudential assessment of acquisitions and increases of qualifying holdings include factors to be considered as an indication that persons are acting in concert. These factors, which do not constitute an exhaustive list, include shareholder agreements and agreements on matters of corporate governance, and other evidence of collaboration such as existence of family relationships, the use by different persons of the same source of finance for the acquisition or increase in holdings in the target undertaking, and consistent patterns of voting by the relevant shareholders.

¹⁹ As per the 2014 Basel standard on measuring and controlling large exposures, two or more natural or legal persons are connected in case they have a control relationship (one of the counterparties, directly or indirectly, has control over the other(s) or they are economically interdependent, that is, if one of the counterparties were to experience financial problems, in particular, funding or repayment difficulties, the other(s), as a result, would also be likely to encounter funding or repayment difficulties).

fitness and propriety or where their previous certification was based on incomplete or misleading information. In the event banks' reporting and disclosure is incomplete or delayed, imposing monetary fines and other types of sanctions and corrective measures (such as restrictions on certain activities, for example, lending, deposit taking, foreign exchange operations, dividend distributions, and potentially amended access to the central bank liquidity facilities) may incentivize the bank and its owners to expedite the process and reduce the scope of illicit activities.

The authorities must stand ready to expel unvetted and opaque shareholders and shareholders that are no longer suitable. Options that competent authorities could explore include the following:

- *Require shareholders to promptly correct regulatory breaches:* This should be possible in cases where the identified problem is of such nature that it can be remedied, for example, by disclosing the identity of shareholders' beneficial owners and applying for their supervisory approval. If the supervisor has already obtained sufficient information indicating that the beneficial owner is not suitable and there is no credible possibility to remedy, the supervisor should be empowered to make an outright request to divest the shares.
- *Order suspended shareholders (or the person or authority to which the shareholder rights have been transferred) to divest their shares on short notice:*²⁰ Although timely action is imperative, the divestiture period could be extended where credible efforts are being made, supported by good faith offers received.
- *If justified, appoint a temporary administrator to take over the banks' management responsibilities during the removal process:* This appointment may be considered where the beneficial owner diagnosis reveals serious irregularities in the bank's management or indicates that senior managers and board members are exposed to influence by the (unvetted and opaque) shareholders, undermining their ability to discharge their fiduciary duties. However, this power needs to be used judiciously, because the appointment of an administrator could undermine confidence and give rise to destabilizing runs. Supplementary concerns about the financial difficulties of the bank should be addressed and potential adverse market reactions managed.
- *Impose pecuniary and other enforcement measures:* Sanctions can be applied at different stages of the enforcement process, including for the failure to dispose of ownership in the manner and within the timeframe determined by the supervisor.²¹ Therefore, they must be sufficiently severe to be credible (dissuasive) in line with a broader sanctioning framework in the relevant jurisdiction.²² The authorities could also be authorized to seize the shares to ensure repayment of pecuniary fines in line with the applicable enforcement procedure for such penalties. Other enforcement measures also include the suspension of voting rights held by the relevant (unvetted and opaque) shareholder in other banks.
- *Remove suspended shareholders:* When shareholders fail to comply with supervisory orders to dispose of their shares, coercive legal measures, compatible with the broader framework, are needed to terminate their shareholder status within a predetermined deadline.
- *Revoke the license and resolve or liquidate the bank:* Where the ownership structure is opaque and shareholders have therefore not been vetted, there is a strong case that licensing requirements are

²⁰ Examples of countries where an instruction to dispose the shares can be made include Belgium, Canada, Georgia, Germany, Indonesia, Kosovo, Kyrgyz Republic, Malaysia, and Serbia.

²¹ For an example of how supervisory agencies define their policies for the imposition of fines under the broader supervisory framework, please see Federal Reserve System 1991, 1997 and 2018, Office of the Comptroller of the Currency 2023a and 2023b.

²² If possible, fines should be applied on a running basis (for example, fines imposed for each day or week that the failure continues).

no longer fulfilled on an ongoing basis. The failure of efforts to expel such shareholders would imply that more intrusive measures are appropriate. In such cases, withdrawal of the license and initiation of a compulsory liquidation may be an option. Where outright liquidation is not deemed practicable, for example, in view of the bank's systemic importance, initiating resolution of the bank and overriding shareholder rights through resolution tools (for example, asset and liability transfers, potentially to a bridge bank) could help ensure operational continuity of critical functions.²³

Subject to the broader legal framework, any value that the former shareholders are entitled to because of the removal process should be used as much as possible to satisfy their liabilities against the bank.

For example, where shares are cancelled by the bank, the competent authority should seek to offset any payment obligation by the bank to such shareholders against their liabilities to the bank. Proceeds (for example, realized through mandatory sales) would be made available to the removed shareholders (beneficial owners), unless this would pose financial integrity issues; for example, where (1) the shareholder is a sanctioned person (United Nations or bilateral targeted financial prohibitions) or (2) there is a suspicion that the funds used to buy the bank shares were proceeds of crime and should thus be confiscated.

Preventing a Resurgence of the Problem

It is important that shareholder transparency and suitability become an integral part of the supervisor's normal course of business. Implementing a sufficiently intrusive supervisory approach and developing the needed supervisory skills are key to ensuring that shareholder suitability becomes adequately embedded in supervisory assessments, activities, and corrective actions. The supervisor should review and update its supervisory procedures and guidelines to ensure effective monitoring of the ownership disclosures and suitability. Banks' ownership structure, including any significant changes in beneficial ownership, should be closely examined, as is recommended by the BCP. Where bank reporting, onsite supervision findings, or any other information give rise to reasonable doubt about the transparency of the ownership structure or the suitability of controlling or significant shareholders, strict suitability (re)assessments should be undertaken followed by appropriate enforcement action.

Jurisdiction-specific legal and policy measures adopted to manage beneficial owners' opacity in systemic problem banks should not be unwound prematurely. Where the authorities have gold-plated their good practices by stricter rules or adopted measures to address more specific circumstances (for example, a notably low threshold for significant interest), such measures may be relaxed or simplified over time. However, this should not happen until a fully transparent and sound banking system is in place and strong institutional capacity safeguards against the resurgence of the problem. Moreover, abrupt relaxation of these measures can undermine legal certainty, given their potential effect on pending administrative, civil, and criminal procedures about past actions concerning bank owners, as well as the effect on the unwinding of related-party exposures.

²³ In the event of systemic banks, this requires the resolution authority to have at its disposal tools and powers for the orderly resolution of banks. See Financial Stability Board (2014).

III. Related-Party Identification and Risk Mitigation

International Good Practices on Mitigating Related-Party Risk

The risks associated with related-party transactions can typically be reduced substantially. When such transactions are conducted on an arm's-length basis in the normal course of banking business and properly monitored, their risk is usually controlled and mitigated. However, related-party transactions have the potential to be unfair, abusive, and potentially fraudulent. Thus, they can expose the bank to reputational damage and financial losses, particularly if timely and decisive supervisory responses are lacking.

International standards establish minimum requirements on related-party transactions for banks and the supervisors to prevent abuses and to address the risk of conflicts of interest. These include:

- *Basel standards:* The BCP and the BCBS' "Guidelines: Corporate Governance Principles for Banks" (2015) provide expectations for banks as well as for their prudential supervisors tasked with regulating and overseeing their governance, risk management, and disclosure frameworks concerning related-party transactions. The aforementioned guidelines also refer to the G20/OECD Principles of Corporate Governance (OECD 2015) with respect to disclosure and transparency requirements relevant to related-party transactions. Further details are discussed subsequently.
- *International Financial Reporting Standards:* The International Accounting Standards Board requires disclosures on transactions and outstanding balances with an entity's related parties. The objective is to ensure that an entity's financial statements contain the disclosures necessary to draw attention to the possibility that its financial position, and profit and loss, may have been affected by the existence of related-party transactions and outstanding balances with such parties.²⁴
- *FATF standards:* To combat money-laundering/financing of terrorism and other threats to financial integrity, financial institutions are to conduct customer due diligence and keep records of their customers for at least five years.²⁵ For legal persons and arrangements, financial institutions are required to understand the ownership and control structure of the customer and take reasonable measures to identify their beneficial owners and verify their identity.

Comprehensive definitions of "related parties" and "related-party transactions" should be provided in laws or regulations. Definitions vary across jurisdictions, reflecting corporate practice. The BCP requires, however, that they be sufficiently broad to capture all relevant parties and transactions that present a risk of potential abuse, and such that they cannot be easily avoided and can be effectively enforced. The BCP also requires that the supervisor have the power (including through laws and regulations) to prescribe a comprehensive definition of related parties and to exercise discretion in applying this definition on a case-by-case basis. These definitions should broadly capture the following components:

- *Related parties* "can include, among other things, the bank's subsidiaries, affiliates, and any party (including their subsidiaries, affiliates, and special-purpose entities) that the bank exerts control over, or which exert control over the bank, the bank's major shareholders, board members, senior management and key staff, their direct and related interests, and their close family members, as well as corresponding persons in affiliated companies."²⁶ Where the legal entities that hold a controlling or

²⁴ IAS 24 on related party disclosures.

²⁵ FATF Recommendation 10: customer due diligence; Recommendation 11: record-keeping.

²⁶ BCP 20: transactions with related parties.

significant interest are concerned, the perimeter of related parties would cover the beneficial owners of these entities as well, in line with the analysis in the second section of this note. The application of related-party definitions to state-owned banks raises additional considerations (Box 6).

- *Related-party transactions* include “on-balance sheet and off-balance sheet credit exposures and claims, as well as dealings such as service contracts, asset purchases and sales, construction contracts, lease agreements, derivative transactions, borrowings, and write-offs. The term transaction should be interpreted broadly to incorporate not only transactions that are entered into with related parties, but also situations in which an unrelated party (with whom a bank has an existing exposure) subsequently becomes a related party”²⁷ (for example, by becoming a significant shareholder). This definition should cover deposits and other liabilities.²⁸

An effective regulatory framework sets out requirements for banks on the identification of related parties and the sound management and governance of the risks associated with related-party transactions and exposures. The BCP and the BCBS “Guidelines: Corporate Governance Principles for Banks” (2015) provide the following:

- *The arms-length rule:* Laws, regulations, or the supervisor should require banks’ transactions with related parties not to be undertaken on more favorable terms (for example, in terms of credit assessment, tenor, interest rates, fees, amortisation schedules, or requirement for collateral) than corresponding transactions with nonrelated counterparties. The transactions with related parties should be conducted in similar conditions, as would be offered to the public or in the market.²⁹
- *Prudential limits for exposures and capital deduction/collateralization:* Banks are required to have adequate policies and processes to identify individual exposures and transactions with related parties, as well as the total amount of exposures. To prevent a bank from having excessive related-party exposures, the supervisors should have the power to set, on a general or case-by-case basis, individual and aggregate limits for exposures to related parties, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures. Practices for setting prudential limits differ across jurisdictions, with some jurisdictions requiring banks to have a limit for related-party exposures, whereas others apply the prudential limits as part of the large exposure regime. When limits are set on aggregate exposures to related parties, those should be at least as strict as those for single counterparties or groups of connected counterparties (that is, 25 percent of a bank’s Tier 1 capital).
- *Corporate governance:* To prevent banks from engaging in abusive self-dealing, their boards are required to develop, implement, and monitor a formal written policy covering conflicts of interest and related-party transactions. This policy should form part of the bank’s governance framework, sending a clear message to all bank personnel and shareholders. The policy should require that related-party transactions (including restructuring) and the write-off of related-party exposures above a certain threshold, or otherwise posing special risk, be subject to prior board approval.³⁰ Board members

²⁷ BCP 20: transactions with related parties.

²⁸ Related-party deposits and other liabilities can raise problems with noteworthy implications on banks’ funding (stability of these deposits), profitability (cost of their remuneration), and resolvability (ranking in liquidation, with possible departure from *pari passu* treatment in resolution).

²⁹ From a corporate law angle, preferential transactions with related parties, in some cases, may qualify as redemption of equity, which should not be possible unless under a capital reduction, mandatory buy back, or liquidation.

³⁰ This threshold may be set by supervisory authorities as a fixed amount or relative to the bank’s capital, though most jurisdictions allow banks to determine it. In some jurisdictions, related-party transactions that exceed the set threshold require the prior approval of the supervisory authority (in Ireland, this threshold is EUR1 million). Special procedures may be contemplated under a “three lines of defense model” and, in some jurisdictions, additional approvals from other corporate bodies (for example, a statutory audit body).

BOX 6. Application of Related-Party Rules to State-Owned Banks

Governance risks involved in related-party transactions are equally relevant for state-owned banks. The BCP does not include specific details on how to deal with related-party transactions in state-owned banks. In principle, state-owned banks should be supervised under the same rules as private banks that carry out similar activities. Many relationships captured by the related-party definition can straightforwardly apply to these banks.

Adjustments to the related-party definition can be considered for the narrow purpose of dealing with state-owned enterprises, without undermining the integrity of the related-party framework. Under the large exposure framework, public sector entities that are not treated as sovereigns should be included in the scope of large exposure limits. However, common ownership by the state will not per se bring two state-owned enterprises into the same risk group, unless there is another ground to consider otherwise (for example, one state-owned enterprise controls the other).

This understanding is also valid in some jurisdictions under their related-party framework. This can be conceivable for the application of prudential related-party limits. However, the underlying concerns about conflicts of interest and abuse remain and are even more important for state-owned banks because of the risk of undue political interference. To mitigate these risks, governance requirements of a related-party framework (for example, the arm's-length rule, board approval requirement, and reporting duties) should apply to dealings with state-owned enterprises. Supervisors should carefully monitor exposures to state-owned enterprises and exposures to the sovereign and, on a case-by-case basis, consider introducing additional limits, restrictions, or capital charges that mitigate the risks of excessive concentration and encourage diversification.¹

Enhancing the governance of state-owned banks could also ensure that the risks associated with related-party transactions are mitigated. Sound governance framework for state-owned banks should be guided by the BCBS Principles on Corporate Governance for Banks and the 2015 OECD Guidelines on Corporate Governance of State-Owned Enterprises (2015).² The latter emphasizes the need for a certain number of independent members on the boards of state-owned enterprises. They also stress that mechanisms should be implemented to avoid conflicts of interest, preventing board members from objectively carrying out their board duties, and to limit political interference in board processes.

Source: See Adams and others 2022.

¹ An example could be drawn from the 2017 China Financial Sector Assessment Program, which found that the definition for related parties is comprehensive but ownership by the state government is not treated as a trigger for related-party reporting, limits, approvals, and enhanced due diligence for loans provided by commercial banks owned by the local government to local government entities. Hence, the Financial Sector Assessment Program recommended to the authorities to bring common ownership of enterprise by local governments into the definition and discipline of related-party transactions.

² A review of the Organisation for Economic Co-operation and Development guidelines is currently under public consultation.

or other persons with conflicts of interest (including persons related to them) should be excluded from the process of granting approval and managing related-party transactions. The banks should monitor and report these transactions through an independent credit review or audit process, and the senior management should monitor the transactions on an ongoing basis, whereas the board should provide oversight. Exceptions to policies, processes, and limits should be reported to the bank's senior management and, if necessary, to the board for timely action.

- *Transparency*: Banks are required to publicly disclose information about aggregate exposures to related parties and material transactions. Transparency is aimed at preventing abusive practices by allowing bank shareholders, depositors, and other relevant stakeholders and market participants to monitor these transactions and keep the board accountable.

Effective supervisory oversight and proper enforcement practices aim to prevent excessive related-party transactions and abuses arising in these transactions. Supervisors must have the legal power to supervise related-party transactions and address unsafe and unsound practices at an early stage. Offsite and onsite supervisory tools should enable supervisors to monitor a bank's policies, processes, and transactions and exposures to related parties (see, for example, Office of the Comptroller of the Currency 2013). Although Basel standards require that supervisors obtain information on aggregate exposures to related parties, some supervisors ask banks to also report individual exposures exceeding a certain threshold.³¹ The supervisor should verify the adequacy and effectiveness of a bank's related-party framework, including governance requirements, in practice and assess the reliability and accuracy of banks' reporting. Ideally, the verification should be in the context of onsite inspections. The risks related to related-party transactions should also be part of Pillar 2 framework. To facilitate the identification of related parties and the proper implementation of regulatory requirements, supervisors should issue guidance to banks on observed good practice and their supervisory expectations. In practice, however, the supervision and regulation of related-party transactions and exposures often warrants improvements (Figure 3).

Dealing with Related-Party Exposures of Systemic Proportions

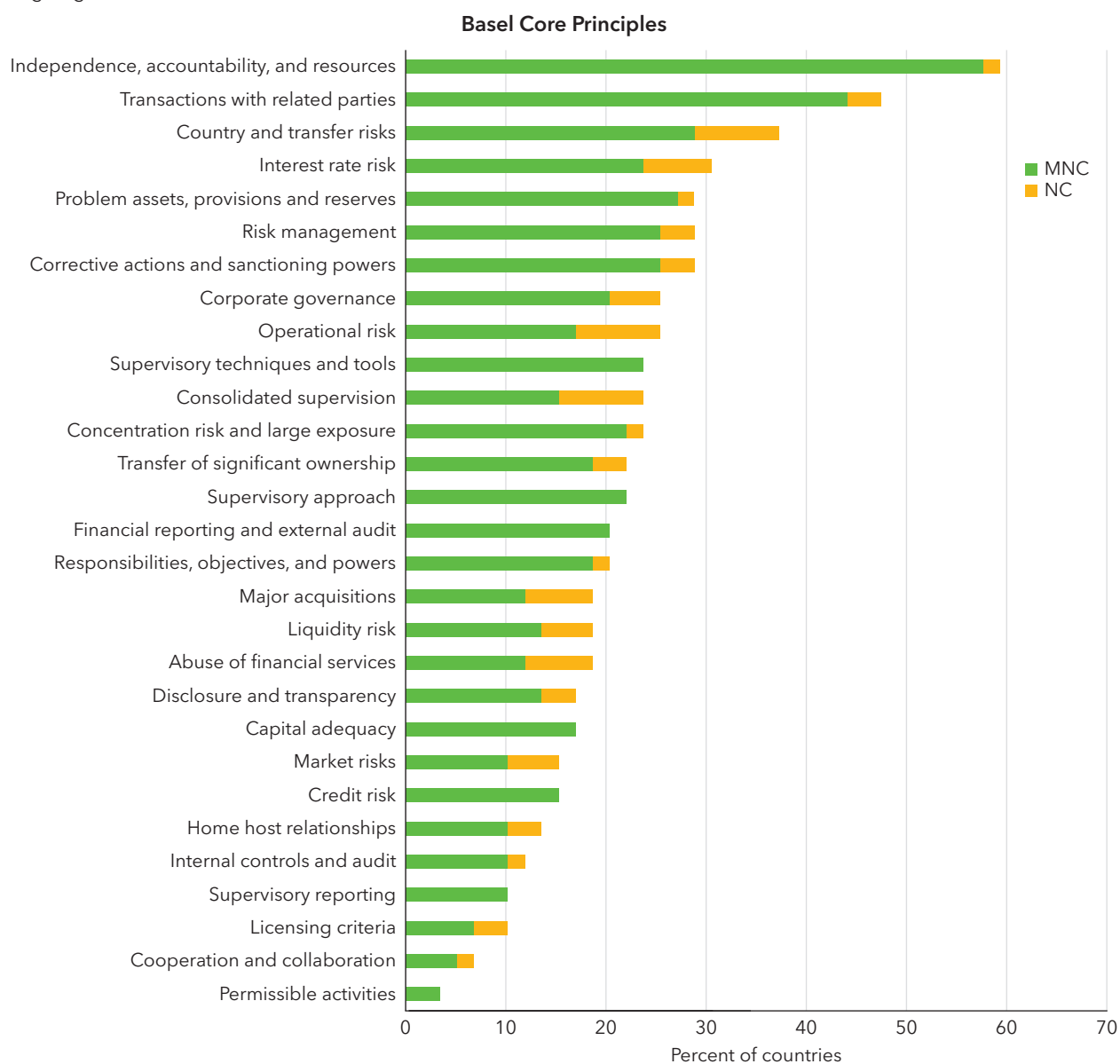
If not managed properly, related-party transactions can quickly become a source of bank weakness and a threat to financial stability. Where such transactions are not conducted at arm's length, loans could be of poor quality and may not generate the expected real cash flows and returns. As a bank's financial soundness deteriorates, banks may increase transactions with related parties to strip assets, hide large losses, and gamble for resurrection, for example, by evergreening bad loans granted to related parties (de Juan 1987, World Bank 2023). Transactions not conducted at arm's length are typically associated with significant problems in a bank's corporate governance (such as senior managers and board members being involved in abusive schemes) and failure of its internal control framework and risk management function. In the absence of proper identification, reporting, and management of related-party transactions (because of narrow legal definitions that do not properly capture various types of relations and considerations), banks' financial and prudential reports could become unreliable, because they will underestimate credit and concentration risk, and potentially overstate liquidity and solvency.

The three-pillar approach offers a structured process for identification and resolution of related-party risks. Supervisory efforts are directed at identifying potential related-party transactions based on predetermined indicators, as a method for identifying a potential related party. The respective bank is then offered due process safeguards by making submissions to the supervisor and challenging its determination of relatedness to the transactional counterparty (for example, borrower or service provider). The approach effectively places the onus on the respective banks to demonstrate that a party is not related.

³¹ In South Africa, for example, banks' quarterly statutory reporting to the Prudential Authority includes all individual related-party exposures that exceed 0.1 percent of qualifying capital and reserve funds, with exposures not equal to or less than 0.1 percent of qualifying capital and reserve funds reported on an aggregate level. In addition, the banks need to attest that all of these related-party transactions are done at arms' length, that the board of directors of the relevant bank or controlling company effectively monitor related-party exposures, and that steps have been taken to control and mitigate these exposures. A separate schedule of all exposures to related persons that are not at arm's length shall, upon request, be submitted in writing to the Prudential Authority.

Figure 3. BCP Assessment Findings

An overall assessment of 60 BCP assessments completed between January 2012 and June 2023 reveals that out of the 29 Core Principles, the level of compliance with Principle 20 on related-party transactions is the second lowest, with almost half the jurisdictions assessed having been rated noncompliant or materially noncompliant. The sample of 60 countries includes the 20 largest global economies.



Source: Adrian and others 2023.

Note: BCP = Basel Core Principles for Effective Banking Supervision; MNC = materially noncompliant; NC = noncompliant.

Pillar I: Strengthening the Legal and Regulatory Framework

The three-pillar approach requires that the legal framework for related-party transactions be first brought in line with international standards and further enhanced to support the use of supervisory judgment. The first step is to bring the framework for related-party transactions and enforcement actions in line with the BCP, and to empower the supervisor to exercise judgment when determining whether a party is related to a bank. These reforms should be guided by high-level principles (Box 7). To safeguard financial stability, the

BOX 7. Guiding Principles for Legal and Regulatory Reforms on Related-Party Lending

The following high-level principles should guide efforts to bring the legal and regulatory framework in line with BCP and FATF standards:

- *Substance over form*: The legal, economic, and commercial nature of the transactions and relationships between a bank and its counterparty should prevail over the form, to prevent opportunities for abuse and to promote rigorous oversight, both by bank management and the supervisor.
- *Integrity*: The arm's-length rule and conflict of interest rules should be observed at all times. Any exemptions to some other aspects of the framework (for example, board approval requirement) should only be allowed under narrowly defined conditions and based on sound policy justifications, subject to the supervisory authority's powers to address risks raised by such situations, including the calibration of limits or requiring that certain transactions be subject to its approval.
- *Materiality*: To avoid unreasonable operational difficulties for banks, various aspects of the related-party framework, in particular the requirement for board approval, may be subject to a materiality threshold.
- *Management responsibility*: The duty of loyalty requires that managers uphold the interest of the bank above the individual interest of shareholders and third parties. This is the basis for the board approval requirement concerning related-party transactions, and for its oversight.
- *Transparency*: Disclosure requirements have been an important strategy employed by corporate laws to control abusive transactions with related parties. This is even more relevant in the case of banks, irrespective of whether they are publicly listed companies.

authorities should ascertain that prospective (credit) losses from related-party exposures are duly captured in supervisory assessments and viability analyses, with the aim to ensure timely initiation of resolution proceedings when banks are found to be unviable, and to have no reasonable prospect of returning to viability. The framework for holding related parties accountable for a bank's failure may need to be strengthened in order to reduce the cost of potential bank resolution and to increase recoveries from these parties.

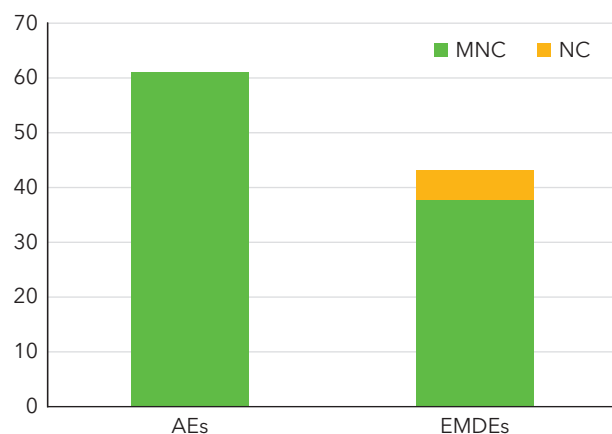
Regulatory gaps should be closed in a way that best supports efforts to identify and resolve related-party transactions within a jurisdiction. A cross-country review of frameworks and supervisory practices in this area reveals material gaps, and more so in advanced economies (Figure 4). Common gaps include:

- Legal definitions of key terms that are unclear or too narrow, failing to capture important groups of related parties and their transactions. Examples include (1) only considering formal ownership of shares; (2) solely using quantitative thresholds; (3) omitting indirect or joint holdings, for example, based on an agreement (a voting agreement); and (4) only considering credit transactions.
- Inadequate legal powers for the supervisor to deal with the risks posed by related-party transactions, which can be amplified by limited powers to request information from third parties.
- Inadequate powers for effective use of supervisory judgment or discretion when exercising supervisory powers.
- No requirement for bank boards to approve transactions with related parties and the write-offs of related-party exposures. No requirement for banks to conduct related-party transactions at arm's length.

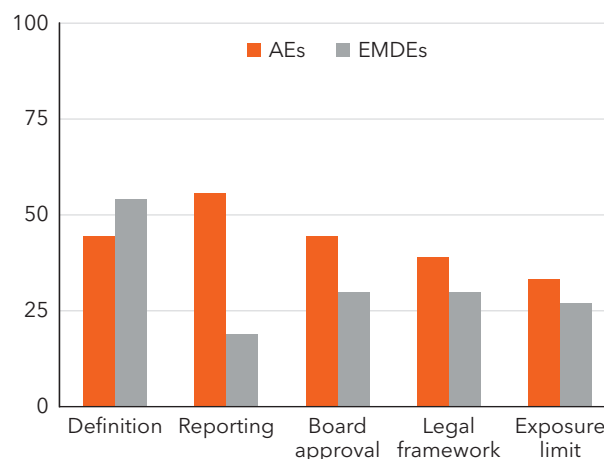
Figure 4. BCP Assessment Findings on Related-Party Frameworks

A review of 55 BCP assessments conducted as part of Financial Sector Assessment Programs completed during January 2012–July 2022 reveals that deficiencies in the related-party frameworks are more frequent in the 18 jurisdictions classified as advanced economies than in the 37 jurisdictions classified as emerging market and developing economies. A significant flaw is the overly narrow definitions of related party and their transactions, or the absence thereof. Deficiencies in reporting, board approval, exposure limits, and legal framework are more common in advanced economies than in emerging market and developing economies.

1. Deficiencies in Related Parties Framework (Percent of AEs or EMDEs countries)



2. Deficiencies in Related Parties Framework (Percent of countries)



Sources: Dordevic and others 2021; and IMF updates.

Note: AEs = advanced economies; BCP = Basel Core Principles for Effective Banking Supervision; EMDEs = emerging market and developing economies; MNC = materially noncompliant; NC = noncompliant.

- Aggregate related-party exposure limits set too high or not at all. Broad exemptions from set levels reduce their effectiveness.
- Inadequate (or no) supervisory reporting requirements or inadequate supervisory oversight of banks' related-party framework and transactions.
- Inadequate AML/CFT framework, including regarding customer due diligence and record keeping. This may result in the banks not knowing the beneficial owner of their borrowers and, thus, not being able to establish relations. This may also prevent the supervisor and Financial Integrity Unit from identifying indirect related-party transactions, that is, transactions where two (or more) banks work together to facilitate related-party transactions.³²

To unwind related-party exposures to contain financial stability risks, the supervisor utilizes its general powers to define criteria and indicators for determining "relatedness." The BCP requires that "laws or regulations provide, or the supervisor has the power to prescribe, a comprehensive definition of 'related parties.' ... The supervisor may exercise discretion in applying this definition on a case-by-case basis."³³ The following are some legal approaches, which are not mutually exclusive, used to underpin supervisory judgment in this area:

- Some jurisdictions empower supervisory authorities to issue rebuttable presumptions to determine relatedness, for example, by assuming relatedness when shareholdings or voting rights exceed a certain threshold (Italy, Thailand), or allow the supervisory authority to assume the existence of such a

³² An example of such indirect related-party transaction is when Bank A receives an interbank loan from Bank B, which the sole purpose of on-lending to Bank B's related party.

³³ BCP 20: transactions with related parties, essential criteria 1.

relationship based on the volume, periodicity, or other conditions of the operations between the bank and other persons/entities (Peru).

- A second category of discretion involves the flexibility to expand the perimeter of related parties beyond the minimum scope defined in law. In Moldova and Thailand, for example, the definition of related party includes any person designated as such in regulations issued by the competent authorities.
- A third option for exercising supervisory discretion allows for case-by-case determinations, based on the risks involved. The Australian Prudential Regulatory Authority, for example, has defined related parties indicatively, but may also require a bank to treat a specific entity as a related party. A similar framework exists in Tanzania.

Frameworks to identify potential related-party transactions could provide a list of typical characteristics (“flags”), ideally, as part of secondary legislation. Informed by cross-country experience and country-specific considerations, these characteristics should refer to the nature of the relationship, as well as to the nature of the transaction (Box 8; Office of the Comptroller of the Currency 2013, 2015; National Bank of Ukraine 2015; National Bank of Moldova 2013). Consideration should also be given to the interplay with large exposure frameworks and, more specifically, the prudential requirements for determining groups of connected counterparties.³⁴ Indeed, the experience of some jurisdictions with material related-party problems shows that although the banks’ immediate related parties, such as managers or controlling shareholders, were mostly known to the authorities, numerous borrowing entities that were de facto connected to these related parties were not reported as such. To close such gaps, jurisdictions added the following elements into their related-party definitions or otherwise allowed the supervisor to consider the following as related parties:

- Any person or class of persons whose direct or indirect interest in, or relationship with, the bank or its related parties might reasonably be expected to affect the bank’s judgment in respect of a transaction (Canada).
- Parties that are economically dependent on the bank or its related parties, in that one party’s failure could result in the failure of the other (Türkiye).
- Any person through whom a transaction is performed in the interest of persons deemed to be related, and which is influenced by such persons through labor, civil, and other relations (Moldova, Ukraine).
- Entities that have received financing, without adequate information concerning their shares or shareholders, including the case of bearer shares (Peru).

The supervisory enforcement framework should be strengthened, as appropriate. The framework should provide for escalating enforcement measures, aimed at providing incentives to banks and their related parties to cooperate during the diagnostic process, and to swiftly resolve any concerns that may materialize.

Regulations, supervisory guidelines, supervisory processes and practices, and reporting templates should be revised to support efforts to identify, manage, and control related-party risk. In addition to the adoption of indicators that could help identify transactions or exposures potentially related to a bank, various other steps should be taken prior to initiating the related-party diagnostics (see next section). These include adopting regulatory reporting forms on related-party transactions and exposures, as well as supervisory (minimum) requirements for managing related-party risks.³⁵ In addition, supervisors should ensure that

³⁴ See BCBS 2014, with subsequent amendments, as well as BCP 19. Also see the guidelines in European Banking Authority 2017.

³⁵ Even when the legal definition of related parties is appropriately broad, supervisory guidelines are needed to facilitate banks’ risk management and internal controls. US Office of the Comptroller of the Currency (2013) and National Bank of Moldova (2013) provide useful examples.

BOX 8. Potential Indicators for Identifying Related-Party Transactions

Country experiences point to various indicators (“flags”) that, when used individually or together, may indicate potential relations, with a final determination to be made on the basis of enhanced investigations that would focus on, among others, the use of funds and source of payments. Some flags on the nature of relationships may also inform the identification of potential concerted activities between multiple parties, and therefore of banks’ beneficial owners.

The nature of relationship:

- *Exclusivity*: For example, no other financial institution unrelated to the bank is lending to the party, and the amount and type of loans do not justify it from an economic point of view.
- *Economic dependency*: For example, most of the party’s revenues come from the bank or its related parties; the party has no significant economic activity or revenues; the level of interconnection to the bank or its related parties is such that economic failure of one would likely imply its own economic failure; and the party acts as nominee mostly for the bank or its related parties.
- *Common infrastructure*: For example, common or very close business addresses (physical or virtual) with the bank and its related parties; common operational structural elements; common managers or staff; and common suppliers, service providers, or customers.
- *Lack of transparency*: For example, the party’s ownership structure is complex, opaque, or its beneficial owner is not known; the bank does not cooperate with the supervisor in clarifying the party’s relationship with the bank; or the party is incorporated in jurisdictions other than its main activity or is in a jurisdiction with high money laundering/terrorism financing risk.

The nature of the transaction:

- *Purpose of the transaction and use of funds*: For example, its purpose does not correspond to the typical economic activity; funds are not used for the stated purpose. The funds are used, directly or indirectly, by related parties of the bank or in their interest.
- *Underwriting standards*: For example, material disproportion between proceeds, tenor, and terms and conditions; legal form of transaction differs from their economic essence; and the terms and repayment conditions differ from the current market conditions.
- *Indebtedness and creditworthiness*: For example, at the onset, the loan is unlikely to be repaid as stipulated in the contract, given creditworthiness and available repayment sources; and credit rating below the minimum considered acceptable by the bank.
- *Irregularities in banks’ processes, evidence, and documentation related to the transaction*: For example, the approval process differed from procedures for similar transactions; there is no evidence that the assets sold or services provided to the bank ever existed; and there are material omissions in the underlying documentation.
- *Interest rates, fees, and prices*: For example, interest rate and fees to be paid to the bank are substantially lower than for clients with similar economic and financial characteristics, and prices paid by the bank for assets or received services differ from market prices.
- *Collateral and guarantees*: For example, collateral and guarantees provided are lower than those required for similar transactions.

sufficient attention is given in their procedures to banks’ corporate governance mechanisms for managing the risks associated with related-party transactions and exposures.

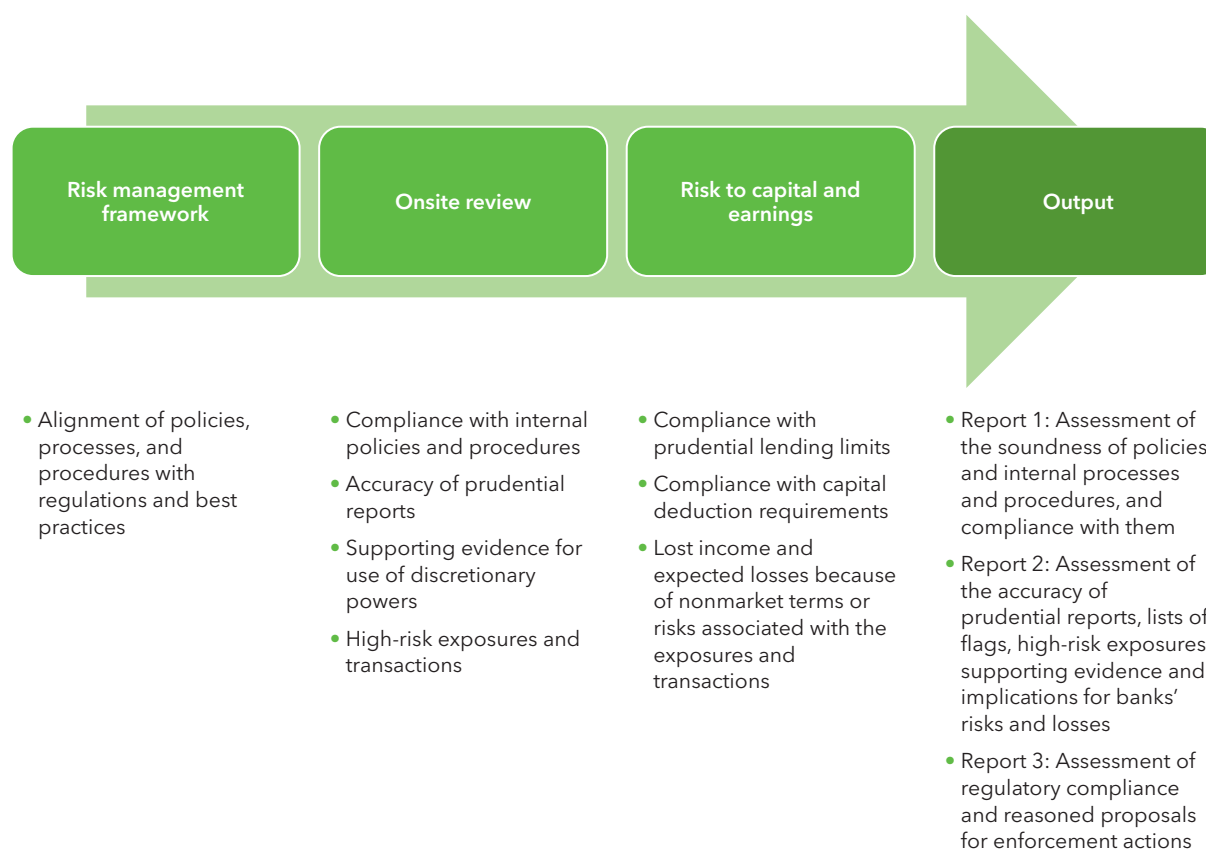
Pillar II: Diagnostic Process

The diagnostic process can commence once banks have submitted related-party reports based on definitions and prudential requirements that are consistent with good practice. In jurisdictions where the legal and regulatory reforms (Pillar I) are not needed to effectively implement the three-pillar approach (that is, because an initial gap analysis found the legal/regulatory framework already to be in line with good practice), reporting requirements will already be adequate and the diagnostic process can therefore start immediately. However, in jurisdictions that have recently implemented legal and regulatory reforms, and introduced new reporting requirements, banks should be given some time to produce their first reports and to update their policies and procedures for managing related-party risks.

Related-party reviews are ideally conducted by experienced supervisors. When dealing with exposures of systemic importance, support could possibly be sought from independent reputable experts, in case of insufficient supervisory resources, lack in adequate supervisory skills, or where the supervisor is in the early stages of establishing its credibility and autonomy. Such assisted reviews would facilitate local capacity building while providing quality assurances. Specifically, external support can come from external advisors (for example, auditors) hired to strengthen the supervisor's skills and resources. In some examples, the authorities may choose to outsource the reviews to an independent reputable firm while retaining overall responsibility. This may be because the reviews are part of a comprehensive asset quality review, the supervisor is unable to mobilize enough resources to conduct the exercise directly, or the involvement of independent external experts is critical to the credibility of the exercise. When reviews are outsourced, banks can be required to pay for them, or costs can be borne by the supervisory authority with ex post recovery from the industry (for example, through a one-off levy).

The scope, depth, timing, and sequencing of related-party reviews should be set out in terms of reference. Similar to third-party diagnostics of banks' asset quality review, terms of reference should provide technical descriptions of how the related-party review will be conducted. Irrespective of whether the reviews are conducted by the supervisor or by an independent firm, the terms of reference should at least include the following:

- The scope of the diagnostics (for example, type of transactions) and the specific methodologies and procedures required for sampling;
- A list of criteria and indicators for identifying potential related-party transactions;
- Procedures for enhanced review and investigations, for example procedures for obtaining official declarations under oath (for example, through preformatted affidavits);
- The information to be provided to the reviewers by the banks (for example, data tapes, records);
- The procedure for modifying any of the previous items, should it become necessary;
- References to applicable laws, regulations, guidelines, and standards, and a description of how the legal definition of related parties may differ from international standards;
- The process for interactive consultation (internally or with the firm) and documentation of how the criteria and indicators to identify related parties are applied, as well as for the resolution of issues that may come up during the reviews; and

Figure 5. Components of Related-Party Reviews

Source: IMF staff.

- Lists and templates for deliverables, including for the required gap analysis, the grading of banks' risk management programs, and the summary information to be provided for each sampled transactions.³⁶

Related-party reviews could follow a three-step process (Figure 5). Preferably, the first two steps should be conducted in parallel, because they are mutually reinforcing. First, an assessment of banks' risk management frameworks for managing related-party risk to ascertain their alignment with best practices and ensure they are adequately documented. Second, onsite reviews to test the effectiveness of the risk management framework and verify the accuracy of related-party reporting. Third, based on the findings from the second step, an assessment of risks to capital and earnings. The final step includes determining compliance with prudential limits and, as appropriate, calculating the required deduction of exposures from the bank's capital base when calculating capital adequacy. Examples where policies and procedures have not been adequately applied, for example, in the case of loans granted and deposits accepted on off-market terms, should be flagged for remediation.

³⁶ Among the deliverables is an assessment of the accuracy of banks' reports on related-party operations. Such a report should include information about each sampled transaction and exposures, including a list of relatedness criteria that are flagged as met. To facilitate the decision-making process, the sampled transactions can helpfully be broken down into six categories: (1) transactions reported by the bank as related-party transactions; (2) transactions that the review found to be related, and were subsequently agreed by the bank as such; (3) transactions with flags, and which the examiners propose be determined as related; (4) transactions with some flags, for which the examiners did not find enough evidence to support or reject relations; (5) transactions with some flags, for which the examiners found enough evidence to reject relations; and (6) transactions with no flags.

The sample of transactions to be reviewed during onsite reviews should be designed to maximize the likelihood of revealing potential risk to capital and earnings. It would typically include credit exposures (1) already reported by the bank as related, (2) not reported as related but representing a significant share of capital, and (3) not reported as related but for which collateral has been foreclosed or accepted in lieu of payment. Loan transactions in the weeks prior to material capital injections (for example, those exceeding a certain percentage of total capital during the past five years) should also be reviewed to ensure that the injections have not been effectively funded by the bank itself.³⁷ The sample should also include some transactions that do not directly involve credit exposures, for example, purchase and sale of financial instruments and nonfinancial assets, acquisition of assets in lieu of loan repayment, and service contracts, such as for asset management, advice, and other major professional services (for example, information technology development, database management, auditing, and loan workouts). The sample should also include deposits or other relevant liabilities that may possibly belong to related parties.

Enhanced reviews and investigations are crucial for gathering evidence to support the use of discretionary powers and enforcement actions. For each transaction that is found to have one or more flags, the examiners should be required to perform enhanced investigations into the use of funds, source of payments, and parties involved. This would include enhanced reviews of loan files and relevant documentation (for example, customer due-diligence dossier, sample signature cards, powers of attorney, affidavits), assessment of the credit underwriting compliance with the bank's internal credit policies and prudential regulations, and follow-up on disbursements (cash and transfers to other banks). Senior bank officers who are responsible for the approval, oversight, and control of the relevant transactions need to be identified and asked to explain relevant flags; notably, those related to the identification of the borrower, use of the funds, and source of repayments. Investigative techniques may include face-to-face interviews to evidence borrowers' debt-servicing capacity and service providers' capacity, and field visits to check the existence and identity of borrowers and the existence of the collateral.³⁸

High-risk transactions should be highlighted for immediate attention, irrespective of any suspected relationship. This is specifically important for transactions that involve disguised counterparties, appear to be designed to transfer losses to the bank, or otherwise lack commercial justification. The bank should be instructed to take decisive actions to mitigate risk to its capital and earnings, for example, by foreclosing on collaterals before they disappear, litigating for damages against bank officers and third parties, and—subject to potential contractual arrangements for modification—eliminating preferential conditions.

The supervisor should collect, analyze, and warehouse information about the characteristics of all in-scope transactions in its related-party reviews. This will help generate key indicators for the quality of credit risk underwriting and the effectiveness and reliability of the governance and risk management of related-party transactions. The supervisory authority should also leverage the existing credit information systems (credit bureau and credit registries), where credit scoring or debt information covered by these systems could be helpful to identify characteristics of related-party exposures.

Pillar III: Enforcement

Using Discretionary Powers in Practice

The supervisory authority should carefully address procedural and substantive matters that may arise when applying supervisory judgment to determine relatedness. In addition to prudential implications, categorization as a related party may have legal consequences for the person concerned, for example, in

³⁷ See Gutierrez, Monaghan, and Piris (2019) for a further discussion of sampling techniques.

³⁸ Such field visits are commonly referred to as "drive-by valuations" and are a useful tool to detect grossly overvalued and nonexistent collaterals, and potential relations between borrowers and beneficial owners.

terms of potential liability or the treatment of claims in resolution or liquidation. The authorities must not shy away from the exercise of their discretionary powers but must be careful to act based on sound reasoning and observe due process, similar to many other supervisory activities.

Strong internal governance and a well-documented diagnostic process support consistent and legally robust application of supervisory powers to determine relatedness. A living document should compile lessons learned during onsite inspections and reflect on discussions between inspectors and legal counsel, decisions made by the team, and so forth. It should include a basic description of the type of information and evidence to be collected to support legally robust identification of relatedness based on each criterion. The governance process for determining a party related to a bank should also be properly formalized and subject to oversight at the supervisor's highest decision-making level.³⁹ High-level oversight can ensure timely guidance and facilitate effective interaction with other domestic and foreign agencies, external service providers, banks, and other stakeholders. Considering its significance, the decision to declare a party related to a bank should also be taken at a sufficiently senior level. Where related-party reviews are conducted by an independent firm, the supervisor needs to prepare its own assessment of the firm's reports, informed by interaction with the firm and a determination as to whether the terms of reference were followed.

The bank should be invited to make submissions and challenge the supervisor's determination prior to the supervisor reaching any final conclusions on relatedness. This may typically be required as a matter of due process. This process can take place after the first diagnostic exercise, based on the new definitions and prudential requirements.

There may be examples where the supervisory authority identifies a party as potentially a related party but decides to exclude the relevant transactions from prudential limits and controls, since their risks are deemed much lower than typical risks of related-party exposures. Such decisions should only be taken after thorough investigation and with strong supporting evidence, and they should be presented to the supervisor's appropriate decision-making body for endorsement. Examples of such decisions may include (1) multinational borrowers with parents of recognized financial soundness, and (2) project financing where the ultimate beneficiary is transparent.

Unwinding Related-Party Transactions of Systemic Proportions

Depending on the severity of the related-party problem, the supervisor determines how much time it will grant banks to unwind excess exposures and other irregular related-party transactions. Although unwinding (that is, bringing banks back to compliance with a related-party framework) should occur as quickly as possible, it may require a few years to do so when related-party exposures have reached systemic proportions. In practice, the timeline for remedial actions should be informed by, among others, (1) the number and systemic importance of banks with observed excess related-party exposures and irregular transactions, (2) the level of their exposures (measured as percent of capital, net of specific provisions against these exposures), (3) the availability of capital to absorb credit losses or additional provisions, and (4) the implications of those exposures for the bank's resilience and viability.

Banks should be instructed to submit credible timebound unwinding plans with periodic targets. Banks should provide a detailed plan to bring their related-party exposures below regulatory limits within a reasonable timeframe, and, as needed, align their terms with prudential requirements (for example, by phasing out preferential terms, in compliance with contractual provisions on modifications). Periodic unwinding targets

³⁹ BCP 2 essential criteria 4 requires supervisors to have effective internal governance and communication processes that enable supervisory decisions to be taken at a level appropriate to the significance of the issue, and timely decisions to be taken in case of emergency. The governance body should be structured to avoid any real or perceived conflicts of interest.

should be expressed in absolute and relative terms, such as overall volume and share of regulatory capital. Only credible unwinding plans should be accepted, as determined by the supervisor. Service contracts with, or outsourcing to, related parties should be made compliant with arm's-length requirements, or otherwise be phased out (that is, not renewed).

There are various ways to unwind and reduce risk from related-party exposures. A credible unwinding plan will typically include one or more of the following options:

- *Repayment of the exposure:* The borrower (that is, the ascertained related party) repays the exposure—including any outstanding arrears—or the bank collects on the exposure through foreclosure, sale of collateral, or other enforcement mechanisms.
- *Setoff:* The bank (or its related-party borrowers) can seek to exercise any setoff rights on a contractual or statutory basis to discharge reciprocal monetary obligations (for example, amounts owed by the related party under a lending arrangement in relation to repayment of a cash deposit placed by that same borrower with the bank), and pursue its legal rights against the borrower for any residual amount. Setoff should be possible only in respect of a related party's due obligations. Otherwise, such a party would be better off than other creditors in a subsequent resolution or liquidation.
- *Disposal of the exposure or debt:* The bank sells the exposure and cancels service contracts. The transfer of debt by the borrower to another debtor upon the bank's consent is also possible.
- *Resolving the relationship:* Where related-party exposures involve legal entities, a change in the entities' ownership could potentially end the "relatedness" of the exposure, without terminating the relevant rights and obligations. Similarly, a change of control of the bank could result in related parties no longer qualifying as such; this would need to be reviewed on a case-by-case basis.
- *Eliminating preferential conditions and strengthening collateralization:* For related-party exposures and transactions that were not made on an arm's-length basis, banks should be required to bring their documentation and terms and conditions up to standard, while recognizing expected losses on those exposures. This work should commence parallel to the unwinding process, subject to potential contractual arrangements for modification.

Implementation of banks' unwinding plans must be closely monitored. At a minimum, banks should be required to report regularly on their unwinding progress and the supervisor should assess progress made. In practice, however, it is preferable that the supervisor and the banks keep close and frequent communication on the progress made in unwinding related-party exposures, especially large exposures, which would allow the supervisor to respond promptly to any indication that the unwinding process is lagging. Targeted onsite inspections are useful to gauge progress in the implementation of the bank's unwinding plans and to reassess the effectiveness of the bank's processes and procedures for handling related-party transactions.

Before recognizing the unwinding as valid from a prudential angle, the supervisor must investigate the underlying transactions. Although this will put pressure on the supervisory authority, the purpose is to confirm that unwinding is genuine, not financed by the bank, or that the underlying risks do not continue in another form. Processes and checklists should be developed for investigating banks' unwinding efforts, including but not limited to the following:

- When exposures to a presumed related party are repaid, the supervisor should trace the flows of repayment to check whether other, nontransparent loans have been extended, effectively resulting in the rollover, or evergreening, of the exposure.⁴⁰ In some situations, investigations may have to be extended to other institutions to avoid borrowers veiling their indebtedness.

⁴⁰ When a bank's balance sheet does not shrink after the repayment of a large related-party loan, this may indicate evergreening.

- When an exposure is sold, the acquirer's potential relations to the original borrower should be investigated, as well as the source of funding. If accepted as proper, the execution of the transactions should be closely monitored. Even greater scrutiny is needed if there is a proposal for the assumption of the debt obligation by a third party.
- When relationships are resolved through a change in bank ownership, the new owners should undergo a strict vetting process, based on the newly revised supervisory framework.
- When banks report that the borrowers' related-party characteristics ("flags") are resolved by a change in the ownership structure of large borrowers, the supervisor should closely scrutinize the transaction to ensure that the entities are truly divested to third parties, and not to strawmen used to veil the relationship between the borrower and the bank.

Deviations from periodic targets of the unwinding plans should not be generally used as a pretext to revise future targets or adjust the timeline of the unwinding plan. The reasons and the circumstances around those deviations should be carefully assessed by the supervisor to determine the appropriate response. In case the supervisor finds that those deviations are not justified, the bank should typically be required to get back on track with its unwinding plan. Enforcement actions could also be considered in line with the preapproved response strategy. Depending on the specific case and based on the supervisory assessment, such action could possibly include requiring the bank to provision against related-party exposures exceeding the target.

Banks whose soundness is jeopardized by excessive related-party transactions, and which fail to unwind these transactions in line with timebound plans, may need to be resolved. When a bank does not make sufficient progress in unwinding excessive related-party transactions and exposures in such a way that may compromise the bank's soundness and viability (including adverse effect on its capital adequacy and other prudential ratios), the supervisor will need to take appropriate enforcement actions, including license revocation and resolution. Available legal mechanisms should be applied to pursue recoveries of relevant amounts from related parties of failed banks.

Special consideration should be given to the treatment of related parties during resolution or liquidation, including the recovery of assets (Box 9). International standards call for the recovery of monies from those culpable for a bank's failure, which may include the bank's related parties.⁴¹ The resolution or liquidation of banks with excessive related-party exposures may entail higher likelihood of requiring funding (for example, to fill the gap between the market value of assets and insured liabilities) from the deposit insurance system or the government. Effective treatment of related parties during resolution and maximizing recoveries from related parties can help reduce losses for the deposit insurer or taxpayers, and, going forward, encourage more responsible behavior (see Box 10 for further details).

Preventing a Resurgence of the Problem

Based on the findings from the diagnostics (Pillar I), banks should be required to improve their related-party risk management framework. Banks should present a credible plan to update their policies, procedures, systems, and controls to comply with the supervisors' new (minimum) requirements on banks' related-party risk management.⁴² Approved by the bank's board of directors, the plan should be submitted

⁴¹ See the Financial Stability Board's Key Attribute 3: resolution powers and Key Attribute 6: funding of firms in resolution (Financial Stability Board 2014); and International Association of Deposit Insurers 2014 Core Principle 12: dealing with parties at fault in a bank failure (International Association of Deposit Insurers 2014).

⁴² The reviews may also reveal the need to further investigate and enforce compliance with other prudential regulations, for example, on credit risk management and customer due diligence programs to prevent abuse of financial services (AML/CFT).

BOX 9. Resolving Banks with Excessive Related-Party Exposures in Türkiye and Indonesia

Türkiye's "Banking Sector Restructuring Program," in response to the 2000 crisis, included comprehensive resolution efforts. During 1997-2003, the authorities intervened in 22 failed banks, representing a quarter of total system assets (Banking Regulation and Supervision Agency 2009; Savings Deposit Insurance Fund 2013).

Most of these failures (16 out of 22) were largely attributed to extensive abuses by beneficial owners of bank resources in a manner affecting viability. Ownership structures were mostly transparent, but gaps in the institutional and regulatory frameworks created an environment exploited by owners. With broad-based institutional reforms (for example, a new autonomous bank supervisory authority) and supervisory reforms (for example, a new banking law more aligned with good practices), the authorities acted decisively to resolve nonviable banks.

During the initial stages of the crisis, onsite inspections in relevant banks confirmed the scope and effect of related-party abuses and nonviability, paving the way for resolution.

Once the crisis was contained, the authorities implemented a program for the remaining banks to strengthen their capital, first by owners and then by the public, if needed. As part of a three-stage audit to identify capital shortfalls, supplementary reporting requirements also covered all related-party transactions. In the end, banks were able to raise the required capital. A considerable portion of the capital deficiency was met by a reduction of related-party exposures (Hoelscher and Quintyn 2003). However, one bank—again heavily involved in related-party transactions—had to be resolved after shareholders failed to recapitalize.

The overall costs of the Savings Deposit Insurance Fund's resolution efforts and deposit payouts for 25 failed banks during 1994-2003 reached \$30.4 billion at the end of 2010 (Savings Deposit Insurance Fund 2013). In the intervening years, the accountability of beneficial owners and the recovery of resolution costs became one of the key policy goals for the authorities of Türkiye (Box 10).

In Indonesia, excessive related-party exposures were one of the key contributors to the country's banking crisis in the late 1990s. Independent audits under a banking sector assessment framework—a simple and immediately operational framework relying only on readily available data—revealed, among others, that the channeling of funds to finance beneficial owners was a common practice. Existing rules on related-party transactions were insufficient and enforced poorly, while supervisory institutions suffered from governance failures.

When efforts to improve banks' financial condition by shareholder contributions failed, resolution became necessary. During the crisis, 66 banks were closed and 13 failed banks were taken over by the Indonesian Bank Restructuring Agency for restructuring purposes. The market share of intervened banks was close to 34 percent (for details, see Enoch and others 2001).

to, and reviewed by, the supervisor without undue delay. During this time, the board should be instructed to regularly monitor progress and ensure that the supervisor is provided with periodic progress reports. Because "normalization" of banks' related-party transaction practices is key to restoring the credibility of the banking system, continuous efforts of reviewing potential related-party transactions are needed, by both banks and their supervisors. Supervisory procedures should be reviewed to include specific reference to risks associated with related-party transactions and exposures. At a minimum, this would include procedures related to supervision of governance and internal controls, and a robust Pillar II supervisory review process. Having the right supervisory skills and approach are very important to preventing a resurgence of the problem.

BOX 10. The Accountability of Beneficial Owners and Related Parties in Resolution and Liquidation

Mechanisms to hold beneficial owners and related parties accountable for the failure of a bank can be administrative, civil, and criminal in their nature. Administrative measures against violations can include fines, although these are likely to be insufficient to recover large losses. Suitability requirements and fit-and-proper rules in the regulatory framework should prevent responsible related parties from being an owner or manager in other banks and financial institutions. As for criminal mechanisms, in addition to general offences, such as fraud or abuse of trust, specific offenses defined for the embezzlement of bank funds or bringing a bank to insolvency may be relevant (Türkiye, Ukraine). For civil accountability, two primary issues are relevant: loss imposition and liability for the recovery of bank's losses. Treatment of related parties in corporate insolvency may also inform the legal and policy choices of a jurisdiction.

Cross-country analysis indicates some common themes regarding the treatment of banks owners and related parties in resolution. The first issue is the hierarchy of claims. Related-party claims may be subordinated to unsecured claims as a rule (Tajikistan, Ukraine). A general subordination, instead of subordination on a case-by-case basis (that is, subordination by court order if it is determined the related party's claim arises from a transaction not carried out at arm's length), can facilitate resolution under time pressure (for example, bail-in and business transfers) and address moral hazard risks. In any event, related-party deposits should not benefit from any preferential treatment granted to other deposits. A second issue is limitations on transfers. The legal framework may ban transferring liabilities owed to all or certain related parties (for example, Angola) during a business transfer. Conversely, where related parties buy the failed bank's assets, there may be a risk of collusion. The transactions can be precluded if such risks are quite high, that is, dealing with systemwide failures connected to abuses by beneficial owners and related parties. If otherwise allowed, such transactions should be subject to intense scrutiny regarding the valuation of assets and the disclosure of business ties. The same is valid for sales by asset management vehicles. Third, avoidance rules can help to claw back monies and other assets from related parties. The authorities should be able to set aside, or to seek a court order to that end, certain suspicious or detrimental transactions during a suspect period before initiation of resolution.

Transactions with related parties can be subject to stricter avoidance rules that provide for a longer suspect period or place the burden of proof on related parties. In Serbia, avoidance is a consequence of unlawful related-party transactions.

The civil liability of beneficial owners and other related parties for a bank's failure may be based on a combination of general and specific rules. The bank can pursue its claims from related parties on different legal grounds, for example, contract, tort, or unjust enrichment. Success of general mechanisms depends on the effectiveness of the judiciary and the ability to pierce the corporate veil to reach the beneficial owners, as well as to trace the assets, especially when they are transferred abroad. To overcome challenges, some jurisdictions that experienced widespread related-party problems introduced special provisions, although some of the measures introduced may not be legally feasible in other jurisdictions.

BOX 10. The Accountability of Beneficial Owners and Related Parties in Resolution and Liquidation (continued)

- In Indonesia, the Indonesian Bank Restructuring Agency was given extrajudicial authority to issue a writ (which has a declarative value) for enforcement, although such writs have been successfully challenged before courts.
- Türkiye's approach after its financial crisis of 1999-2001 was comprehensive. The abuse of bank resources is a resolution trigger. Failed banks' managers and owners are subject to personal bankruptcy under certain conditions. The Savings Deposit Insurance Fund was given strong recovery powers. Damages caused by bank owners and related parties were treated as "public receivables," so that the Savings Deposit Insurance Fund could enforce them administratively, similar to tax claims. It could take control and management of legal entities owning the bank or entities controlled by bank owners, with the power to sell such entities' shares and assets as a "commercial unity." Together with criminal accountability, these powers incentivized most bank owners to seek settlement agreements with the Savings Deposit Insurance Fund. The Turkish case indicates that accountability of related parties and asset recovery efforts can be successful under strong political commitment, an adequate legal framework, and support by judiciary and law enforcement agencies.
- In Moldova and Ukraine, special provisions allow lifting the corporate veil and authorizing the liquidator to apply to court for damages inflicted by related parties based on the liability grounds defined in law. In Ukraine, the special liability framework evolved over time, resembling some aspects of the Turkish approach, such as stronger evidence rules, extended statute of limitations, rebuttable presumptions to facilitate interim measures, and exemptions from court fees to reduce the cost of recovery efforts.

IV. Conclusions

Shortcomings in identifying beneficial owners and mitigating risks stemming from related-party exposures, which are core to many banking failures, continue to loom large. Opaque bank ownership structures may arise for various reasons (for example, gaps in the legal framework, supervisory failures, and lack of adequate systems for holding information on beneficial owners), potentially undermining the integrity and safety of banking systems. Effective monitoring of beneficial owners is thus a core pillar of bank supervision, AML/CFT frameworks, and tax transparency. Similarly, good practices will minimize the risks associated with related-party transactions. However, Financial Sector Assessment Program findings show that these good practices are often missing in both advanced economies and emerging market and developing countries. Hence, efforts to strengthen transparency and prudent behavior by bank owners, and to mitigate risks from related-party transactions, remain a key priority.

The three-pillar approach presented in this note seeks to provide a flexible framework for country authorities seeking to deal with widespread opacity in ownership structures and related-party exposures of systemic proportions. By combining (1) legal reforms that foster full alignment of legislation and supervisory frameworks with international standards, (2) comprehensive diagnostics to unveil beneficial owners and identify related parties, and (3) targeted enforcement efforts, authorities can respond effectively to systemic problems that, if left unchecked, may pose significant legal, financial, and reputational risks. The suggested approach provides the main building blocks for a comprehensive strategy to address systemic problems, while promoting greater transparency and better risk management standards going forward. However, country authorities must always consider whether any modifications are necessary in this three-pillar approach, because tangible actions always need to be tailored to country circumstances.

Two principles shape the recommendations of this note: transparency and accountability. The provision of key information to supervisors is necessary to ascertain banks' continuous compliance with licensing requirements. Broader disclosure of selected items is justified to enable depositors, market participants, and other stakeholders to effectively monitor how banks conduct their business and, more broadly, promote accountability. In particular, basic information on beneficial owners should be made readily available by banks to the general public. In addition to reinforcing robust governance and transparency standards, the legal framework should also provide for mechanisms to hold bank owners, managers, and other related parties accountable for leading a bank to failure through fraud, gross misconduct, and asset stripping. Enforcing these mechanisms is critically important to rebuild confidence, especially in situations where systemic problems with ownership structures and related-party exposures have jeopardized financial stability or prompted bank failures.

Independence, adequate resourcing, and close cooperation between the competent authorities—key success factors of the strategy for addressing systemic problems with opaque bank ownership and related-party transactions—warrant careful consideration. Given the complexities associated with the process, consideration should be given to appointing a dedicated project manager and establishing specialist teams, with mandates and responsibilities approved by the supervisor's highest decision-making body, and adequate resources being made available. To ensure good governance, the exercise should be subject to an adequate oversight and decision-making process, possibly involving a dedicated steering committee that includes representatives from all relevant stakeholders. In countries where problems with governance, rule of law, and corruption have been pervasive, and the supervisor's independence is only recently enhanced, the authorities may need to repeatedly communicate their new policy of shareholder transparency and suitability, and of compliance with prudential requirements on related-party transactions. This can help shield the supervisor from persistent political and industry interference and speed up the process of policy implementation.

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