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NO MORE SWEET DEALS: The Need to Reform Banks' Related Party Transactions

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CONTENTS

ABBREVIATIONS

BES	Banco Espírito Santo
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principle for Effective Banking Supervision
CEO	Chief Executive Officer
CRD	Capital Requirements Directive
DSO	Division of Structured Operations
EC	Essential Criteria
EBA	European Banking Authority
ECB	European Central Bank
EU	European Union
EUR	Euro (currency)
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GHC	Ghanaian Cedi
IAS	International Accounting Standard
IMF	International Monetary Fund
LEI	Legal Entity Identifier
NPL	Non-Performing Loan
OECD	Organisation for Economic Co-operation and Development
PEP	Politically Exposed Person
PRA	Prudential Regulation Authority
RP	Related Party
RPT	Related Party Transaction
SEC	Securities and Exchange Commission
SOB	State-Owned Bank
SOE	State-Owned Enterprise
SSM	Single Supervisory Mechanism
SupTech	Supervisory Technologies
UK	United Kingdom
USD	United States dollar (currency)
WB	World Bank

PREFACE

This Paper was jointly written by the Financial Sector Advisory Center (FinSAC) and the Financial Stability and Integrity Unit (EFNFS), both part of the World Bank's Finance, Competitiveness, and Innovation (FCI) Global Practice, and the World Bank/ UN Office on Drugs and Crime Stolen Asset Recovery initiative (StAR). It was prepared by Pierre-Laurent Chatain (Team Lead and Lead Financial Sector Specialist, EFNFS), Ezio Caruso (Senior Financial Sector Specialist, EFNFS), Matei Dohotaru (Senior Financial Sector Specialist, EFNFS), Solvej Krause (Economist, EFNFS/ StAR), and Juan Ortiz (Senior Financial Sector Specialist, EECF2). The authors wish to thank Jean Michel Lobet, Miquel Dijkman, Alex Berg, Valeria Salomao Garcia, Susan Maslen, and James Anderson (all World Bank Group), Constant Verkoren, Aldona Jociene, Edda Ros Karlsdottir, and Rachid Awad (all International Monetary Fund – IMF) and Elise Bean (expert) for their useful comments, input, and suggestions. The authors are also grateful to Jean Pesme (Global Director, EFNDR) and Mario Guadamillas (Practice manager, EECF2) for their guidance and to Elizabeth Price for her help. The views, thoughts, and opinions expressed in the text belong solely to the authors, and not necessarily to the authors' employer, organization, committee, or other group or individual.

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- Bank of England
- Central Bank of Ireland
- Bank of Spain
- Bank of Portugal
- Prudential Control and Resolution Authority (ACPR) (France)
- European Banking Authority
- European Central Bank
- National Bank of Moldova
- National Bank of Ukraine[1]
- PwC (Portugal)
- Deloitte (France)
- Caixa Geral de Depósitos (Portugal)
- Groupe BPCE (France)
- Groupe Credit Mutuel (France)
- HSBC (UK)
- Standard Chartered (UK)
- Santander (Spain)
- Bankia (Spain)
- BBVA (Spain)
- Scotia Bank (Ireland)
- PTSB (Ireland)

1 Fieldwork in Ukraine took place before Russia's invasion of Ukraine; however, the analysis from this country remains valid.

EXECUTIVE SUMMARY

i. **In banking, transactions with related parties (RPTs) refer to financial transactions, including loans, investments, guarantees, or other agreements, conducted between a bank and its related parties (RPs).** As defined by the Basel Committee on Banking Supervision (BCBS) (Basel Core Principle (BCP) #20 for effective banking supervision), RPs are entities or individuals that have a close relationship with the bank, either through ownership, control, or significant influence. These parties could be a bank’s major shareholder, a board member, someone in senior management, their direct and related interests, and their close family member as well as corresponding persons in affiliated companies. Although not inherently harmful, RPTs have become a breeding ground for abuse due to potential conflicts of interest and decisions driven by improper motives.

ii. **Despite governments’ and standard setting bodies’ efforts to curtail the issue over the last two decades, recent examples of abusive RPTs abound, both in emerging and advanced economies.** In Ukraine for example, during the period of 2014-2016, the nation grappled with a severe banking crisis that led to the collapse of nearly half of its banking institutions. This crisis was exacerbated by widespread RPT abuse, with several banks being treated as mere "pocket banks" by their owners, resulting in massive losses and a significant impact on public confidence. Moldova provides another striking illustration, where three banks saw around USD 1 billion vanish from their balance sheets in 2014, causing a banking fraud of staggering proportions relative to the country's GDP. Iceland’s 2008 banking crisis, precipitated in part by RPTs and insider lending, showcases how large exposures to connected businesses went undetected, ultimately leading to the collapse of three major banking institutions. In Ghana, RP transactions played an important role in what has been referred to as Ghana’s banking crisis, leading Bank of Ghana to withdraw in 2017 the licenses of several banks as a response to poor corporate governance, false financial reporting, and insider dealings. In certain cases, these transactions have not only affected the financial stability of the involved banks but also the broader financial sector and, in the most severe instances, the entire economy, burdening taxpayers.

iii. **Abusive RPTs stem from various root causes, including weaknesses in the legal, regulatory, or corporate governance frameworks of banks and power imbalances within their decision-making processes.** Problems may arise from unclear or narrow definitions of RPTs, failing to capture the full scope of interests involved. Deficiencies in corporate governance may allow certain interests, such as those of beneficial owners, chief executive officers (CEOs), or majority shareholders, to prevail at the expense of others due to inadequate statutory or organizational safeguards. Ineffective internal and external control functions may also contribute to this issue. Additionally, regulatory frameworks may lack clear guidelines on the responsibilities of a bank's board, leaving it to the bank itself to define the board's role. The lack of corporate transparency, which enables politically influential individuals or individuals who are not "fit and proper" to own or control financial institutions through opaque corporate structures, is also a critical challenge for supervisors, making it difficult to identify potential conflicts of interest.

iv. **More exogenous factors can contribute to abusive RPTs, such as political pressure on supervisory actions or the absence of a professional, expert judiciary.** When supervisors lack robust legal protection or cannot exercise their functions independently, abusive RPTs may occur even when the problematic nature of the transaction is identified. Physical intimidation and fear of retribution can deter supervisors from intervening. In cases where supervisory actions are challenged and the judiciary lacks financial sector expertise, it may fail to recognize a supervisor's professional judgment regarding the relatedness of parties or the true nature of a professed beneficial owner, allowing transactions to proceed despite the need for intervention.

v. **Diagnostic work conducted by the World Bank (WB) and the International Monetary Fund (IMF) under the Financial Sector Assessment Program (FSAP) reveals poor compliance with the international standard governing RPTs.** Among a sample of 47 countries that underwent an FSAP in recent years, 20 were deemed materially non-compliant, and two were non-compliant. The most common problem identified was a non-comprehensive definition of RPs, which omitted certain groups with whom banks had commercial relationships. Many countries struggled to establish a clear framework for RPTs, as the definition typically covered lending but excluded other types of transactions. Supervisors lacked discretionary powers to apply the definition of RPs on a case-by-case basis. Moreover, practices around disclosure and reporting of RPTs were found to be uneven across the board.

vi. **Fieldwork conducted by the World Bank for the purpose of this paper also reveals concerning patterns of abuse in RPTs due to multiple regulatory and supervisory loopholes.** The concept of RPs lacks harmonization, with definitions varying significantly. Responsibilities of the board in approving RPTs are inconsistent, lacking a well-defined role. Other major issues include failures in internal control mechanisms, breaches of prudential limits, deviations from the bank's decision-making processes, which go unnoticed by the second and third lines of defense internally, and occasionally escape checks by the external audit function. Insufficient due diligence and fit and proper assessments during the licensing process, along with limited attention to RPTs during on-site examinations, also emerge as critical shortcomings.

vii. **These findings suggest that the issue of RPTs is not receiving the attention it deserves.** It became overshadowed by the post-global financial crisis regulatory agenda, focused on capital and liquidity, and then by the COVID-19 pandemic. Crises connected to undisclosed RPTs that have affected financial stability or put a high burden on taxpayers clearly indicate an urgent need for a fundamental change in the approach toward RPTs. Interviews conducted during this study showed that some countries have responded to the crises by engaging in significant transformations of their legal frameworks, introducing tools, cooperation models, and supervisory processes to protect their economies from suffering similar consequences in the future. These initiatives are welcome, but there is more to be done at several levels.

viii. **To address these problems, this paper presents a comprehensive set of recommendations.** Regulators are urged to develop and enforce robust regulations specifically tailored to RPTs, aligning them with international standards and best practices. Supervisors should enhance their oversight mechanisms and adopt a risk-based approach to monitor RPTs, with increased intervention powers when abuses are detected. Banks themselves play a crucial role in mitigating risks and should strengthen their corporate governance frameworks, establish clear policies and procedures for managing RPTs, and enhance internal controls and reporting systems. Standards-setting bodies are encouraged to expand the definitions of RPs and their transactions, strengthen supervisory reporting requirements, and issue guidance on RPTs.

ix. **Failure to address the issue of RPTs will only darken the prospects of financial stability, already fragile in the current context.** The absence of reform will allow continued abuse and exploitation of RPTs, escalating risks to financial stability and integrity. It perpetuates a lack of transparency and accountability, eroding public trust in the banking sector. Additionally, it can result in significant financial losses for taxpayers who bear the brunt of potential economic crises. Failure to address the root causes of RPT problems hinders efforts to establish a level playing field and fair competition within the financial system, undermining the effectiveness of regulatory frameworks and supervisory practices, and weakening the overall resilience of the banking sector. Therefore, it is imperative to take multiple actions to substantially reform the issue of RPTs. By implementing the recommended measures proposed in this paper, legislators, regulators, auditors, supervisors, banks, and standards setters can collectively mitigate these risks, safeguard financial stability, and protect the interests of taxpayers.

Table 1. Summary of recommendations/areas for consideration

Recommendations for National Legislatures and Executive Authorities	Grant supervisors independence and legal protection (in legal framework and practice)
	Broaden legal definitions of RP and RPTs, and allow case-by-case determinations
	Establish a clear and uniform definition of beneficial ownership enshrined in the law or regulations, in line with international standards
	Improve quality of information in corporate and beneficial ownership registries and ensure efficient access for bank regulators, supervisors, and financial institutions
	Place the burden of proof on those challenging RPT determinations taken by Supervisors
	Apply deterrent penalties to banks, senior managers, members of boards, shareholders, and other relevant individuals
	Improve consolidated supervision to capture RPTs at group or conglomerate level
Recommendations for National Supervisors	Set up prudential limits for exposures to RPs, deduct such exposures from capital when assessing capital adequacy, or require collateralization of such exposures
	Require banks to publicly disclose their shareholders above certain thresholds
	Foster the role of internal and external audits and risks management functions on RPTs
	Strengthen the licensing process to facilitate scrutiny of RPTs
	Periodically reassess transparency and the fit and proper conditions of bank owners
	Reinforce RPT scrutiny during on-site examinations
	Address RPT problems specific to state-owned banks
	Seek independent third-party opinions on RPT risks
	Provide guidance on what constitute transactions outside market conditions
	Increase banks’ disclosures on RPTs
	Get prepared to resolve systemic RPTs within a jurisdiction
	Foster domestic and international cooperation and information exchange among supervisory authorities

Recommendations for Banks	Strengthen boards’ approval and oversight
	Proactively use beneficial ownership information for vetting shareholders, clients, and identifying RPs and their RPTs
	Develop robust whistleblower mechanisms
Considerations for Standard Setter Bodies	Expand the definitions of RPs and their RPTs; enhance supervisory reporting requirements through more granular information
	Issue supervisory guidance on RPTs
Other initiatives worth considering	Encourage adoption of the Legal Entity Identifier to better trace relationships between parties
	Explore supervisory technology (SupTech) solutions to support continuous monitoring of bank ownership as well as identification and oversight of RPTs

CHAPTER 1

TYPOLOGIES OF BANKING FAILURES CAUSED BY TRANSACTIONS WITH RELATED PARTIES AND THEIR IMPACT

This chapter describes different manifestations of the types of problems that can arise from RPTs in a sample of countries, both developed and emerging, over the past two decades. It provides insights on their different magnitude and financial impacts on local economies. Further, by discussing the varying motivations of those directing the activities in question (from benevolence to negligence to criminal intent) the chapter aims to deliver a typology of different RPT scenarios from which some lessons can be drawn.

Introduction

1. **Many standards and other sources define the concepts of "related parties" and their "transactions", but the BCP definitions are most commonly used for prudential regulation and supervision.** According to BCP #20, footnote 73, RPs 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 that exerts 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. Transactions with RPs (BCP #20, footnote 74) include on-balance 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 RPs but also situations in which an unrelated party (with whom a bank has an existing exposure) subsequently becomes a RP (for details on the different standards relevant to RPTs, see **Annex 1**).

2. **There is nothing wrong per se with entering into transactions with RPs.** These transactions are legitimate activities if conducted within certain limits and in compliance with international standards and can be economically beneficial especially in a company group structure.[2] Therefore, prohibiting such transactions is not considered as a solution except in some specific cases, such as company loans to its directors.[3]

3. **At the same time, close ties between banks and borrowers carry inherent risks.** They can allow insiders to divert resources from depositors or minority shareholders to themselves. They can also be exploited by insiders to evade the bank's compliance and anti-money laundering controls to channel illicit funds through the bank. Such situations are exacerbated when such behavior is systemic and escapes the scrutiny of external auditors and, most importantly, supervisors. RPTs can adversely impact the soundness and viability of a bank, trigger systemic risks to financial stability, and compromise financial integrity, including through corruption, financial fraud, and money laundering. Using examples from several visited jurisdictions, both advanced and emerging, the following section shows how the misuse of RPTs can result in financial ruin for the financial institutions involved, circumvention of internal compliance and anti-money laundering controls, and negatively impact taxpayers and public finances, while enriching the perpetrators behind the scheme.

Section 1. Some Examples of the Role of Transactions with Related Parties in Banking Crises and Bank Failures

Ukraine (2014-2016)

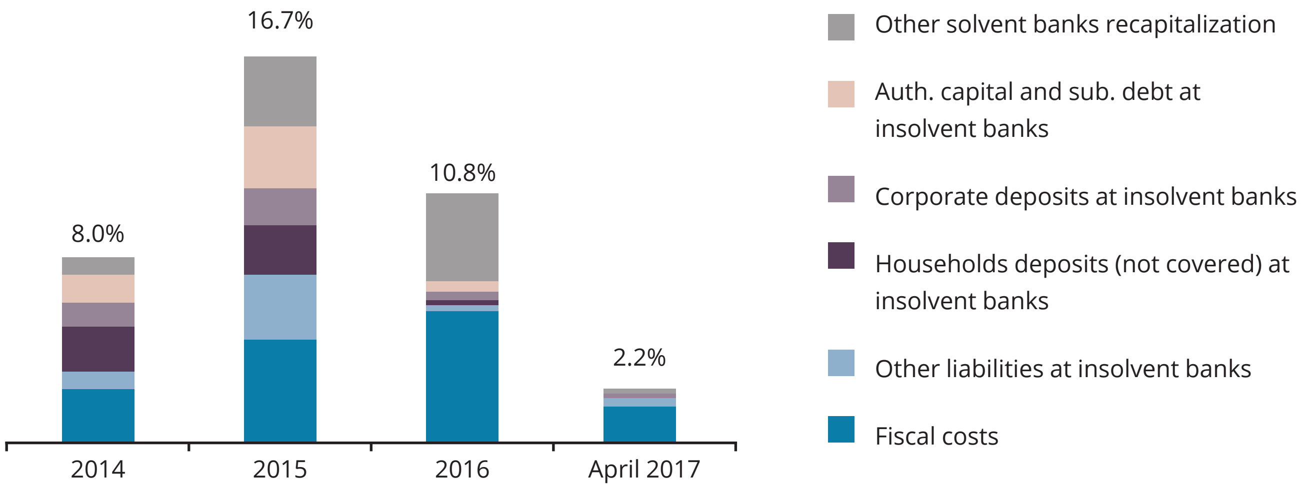
4. **Between 2014 and 2016, Ukraine experienced the most severe banking crisis in the country's modern history.** In a matter of three years, almost half of the banks went bankrupt, including large and well-known institutions. This was the result of a combination of factors, including malpractices in the banking sector. In multiple cases, those banks were not involved in typical financial operations and instead were treated as "pocket banks" by their owners to obtain funds intended for doing business in other sectors of the economy. In the case of PrivatBank, for example, 97 percent of the loan portfolio was RP lending, involving vast sums being paid to companies owned by the owners of the bank and their associates pursuant to what the bank alleged were sham loan agreements that were never repaid, resulting in the bank suffering a loss of at least USD 5.5 billion.[4]

2 Flexibility and Proportionality in Corporate Governance, OECD, November 6, 2018, at: https://www.oecd-ilibrary.org/sites/9789264307490-9-en/index.html?itemId=/content/component/9789264307490-9-en

3 https://www.oecd-ilibrary.org/sites/9789264307490-9-en/index.html?itemId=/content/component/9789264307490-9-en

4 NBU press release at https://bank.gov.ua/en/news/all/kroll-pidtverdili-do-natsionalizatsiyi-pat-privatbank-bulo-obyektom-masshtabnih-ta-skoordinovanih-shahrayskih-diy-scho-prizvelo-do-zbitkiv.

Chart 1. Total direct losses of the economy from the banking crisis in Ukraine, % of GDP



Source: National Bank of Ukraine

5. **Bank failures resulted in significant financial costs and undermined public confidence in the banking system.** According to the National Bank of Ukraine,[5] the direct cost of resolving the crisis was an estimated 14 percent of gross domestic product (GDP) and the total cost, including the direct cost to the private sector, was an estimated 38 percent of GDP (see **Chart 1**). For other sources, the losses incurred by the state and banking sector clients between 2014-2016 are estimated to have exceeded USD 20 billion (23 percent of Ukraine's GDP in 2016).[6] These losses included clients' uninsured lost deposits, state payouts to insured depositors, unpaid central bank refinancing loans, the costs of refinancing, and costs of recapitalization from the state budget.[7] The crisis had a significant impact on public confidence in banks.

Bulgaria (2014)

6. **The issue of RPs has also been a matter of concern in Bulgaria.** Corporate Commercial Bank AD, commonly called Corpbank or KTB, was a Bulgarian commercial bank,[8] that collapsed following a bank run in June 2014.[9] KTB was subsequently closed by the authorities while its main owner left the country. Multiple problems were discovered by a comprehensive external audit of the bank commissioned in July 2014 by the Bulgarian Parliament; among the problems flagged, RPTs were one of the most salient.[10] A considerable part of KTB's credit portfolio suggested a significant connectedness between debtors and the majority shareholder of the entity. The Bulgarian National Bank assessed KTB right after its collapse and noted misappropriation of depositors' money, malpractice of governance, and breach of regulations.[11]

5 Financial Stability Report, June 2017: https://bank.gov.ua/en/news/all/zvit-pro-finansovu-stabilnist-cherven-2017-roku

6 USD 25 billion according to certain sources: https://www.riskscreen.com/kyc360/news/ukraine-unpunished-bank-fraud/

7 Rafał Sadowski, 2017. The aftermath of the crisis an overhaul of Ukraine's banking sector. Center for Eastern Studies: https://www.osw.waw.pl/sites/default/files/prace_67_aftermath-of-crisis_net.pdf

8 According to official data from the Bulgarian National Bank, at the end of November 2013, Corpbank was the fourth largest bank in Bulgaria in terms of assets, third in terms of net profit, and first in terms of deposit growth.

9 Reuters, July 4, 2014: https://www.reuters.com/article/us-bulgaria-banking-insight/accusations-fly-in-bulgarias-murky-bank-run-idUSKBN0F90SG20140704

10 At the end of June 2014, KTB's RP exposure amounted to 33.5 percent of its capital base, a significant increase from the 3.9 percent figure reported at end-2013. This was the result of auditors' reclassification of a significant exposure to the main shareholder (IMF report, Bulgaria: FSAP - Detailed Assessment of Observance on the Basel Core Principles for Effective Banking Supervision, October 29, 2015).

11 https://www.bis.org/review/r141211b.htm. See also IMF Technical Note on the Financial Safety Net and Crisis Management for Bulgaria, section D, page 12 on the Collapse and Liquidation of Corporate Commercial Bank (KTB): https://www.imf.org/en/Publications/CR/Issues/2017/07/11/Bulgaria-Financial-Sector-Assessment-Program-Technical-Note-Financial-Safety-Net-and-Crisis-45060

7. **Public money was needed to be able to pay out all claims.** Subsequent to KTB's collapse, the State Deposit Guarantee Fund paid out 3.6 billion leva (about USD 1.8 billion). The Fund did not have enough money at the time and required an extra injection of about 2 billion leva from the Government, which pushed the country's budget deficit to 5.4 per cent of GDP in 2014, in order to pay out all claims.[12]

Moldova (2014)

8. **Another striking example of abusive RPTs was the collapse of three banks in Moldova in 2014.** In late November 2014, Banca de Economii SA, BC Banca Sociala SA, and BC UNIBANK SA, made the headlines when it was found that about USD 1 billion had disappeared from the three banks' balance sheets, which, at that time, accounted for about 12 percent of the country's GDP, making this banking fraud one of the largest in the world relative to the size of the country's economy.

9. **All three banks registered significant changes in their shareholder structures in the years preceding the final stage of the fraud.** According to a forensic investigation commissioned by the National Bank of Moldova and carried out by a consulting company,[13] in 2012, the only shareholder of BC UNIBANK SA sold 100 percent of its shares to twenty-two new shareholders, including political figures. Each of the new shareholders bought stakes of less than 5 percent of the bank's capital, the qualifying threshold for the supervisor's vetting process for bank owners. This fragmentation of ownership just below the qualifying holding threshold was done intentionally to circumvent the supervisor's vetting process which, at that time, required all transfer of ownership in banks equal or above 5 percent to pass a fit and proper test. As a result, the entire change in the bank's corporate structure, including the identity of the twenty-two new beneficial owners, escaped National Bank scrutiny. The same take over process also took place at BC Banca Sociala SA. A different acquisition scheme was used in the case of the largest bank in the group - Banca de Economii SA. The state, which was the main shareholder, decided to reduce its holdings in favor of private investors, which ended up being a part of the same group that was already controlling the other two banks.

10. **The banks were used as a carousel borrowing scheme.** Investigators identified[14] that the acquisition of controlling interests was the result of concerted efforts on the part of the beneficial owner, the Shor Group owned by a young businessman and local political figure, to gain control of the banks and to conceal their control using an established network of nominees, shell companies, and offshore accounts.[15] A carousel borrowing scheme involving multiple RPs was applied, with loans at one bank paid off with loans from another.

11. **The fraud had widespread consequences for the country.** In the aftermath, the lenders were depleted of real liquidity, leading them to insolvency and requiring an almost USD 1 billion state bail-out to rescue depositors, 12 percent of GDP at that time.[16] But the consequences of the fraud went well beyond taxpayers. There were several other direct and indirect implications:

i. **Sharp depreciation of the national currency.** The national currency depreciated by 40 percent in the months immediately following the final stage of the fraud, which in turn led to an increase in non-performing loans (NPL), particularly of foreign exchange loans, a sharp decrease of consumption,[17] and a change in the structure of banks' deposits, which further affected the banks' foreign exchange positions and their lending capacity.

12 The Sofia Globe, June 2018: https://sofiaglobe.com/2018/06/21/factfile-bulgaria-corporate-commercial-bank-insolvency-four-years-on/

13 https://www.bnm.md/files/Kroll_%20Summary%20Report.pdf

14 Kroll, Report prepared for the National Bank of Moldova, Project Tenor II, Summary Report, December 20, 2017 at: https://www.bnm.md/files/Kroll_%20Summary%20Report.pdf

15 It was also established that acquisition in the three Moldovan banks was largely funded by Shor Group companies, either in part from loans granted by the banks themselves or from what appear to have been loans to companies or individuals linked to Shor with accounts at two Russian banks.

16 https://www.reuters.com/article/uk-moldova-fraud-insight/insight-billion-dollar-bank-scam-shakes-faith-in-little-moldovas-pro-eu-leaders-idINKCN0QF1KA20150810

17 As imported products became much more expensive in a very short period of time.

ii. **Decrease of remittances.** Remittances dropped because people lost confidence in the banking system. This put even more pressure on the exchange rate and balance of payments.

iii. **Significant reduction in bank lending.** All banks almost completely stopped their lending operations in the wake of the crisis as a result of a very volatile macro-economic environment and tight monetary policy requirements to contain inflation.

Iceland (2008)

12. **Iceland experienced a major banking crisis in 2008 that was in part triggered by transactions with RPs and insider lending.** Iceland's three largest banks - Kaupthing, Glitnir and Landsbank - made up 80 percent of the country's financial system at the time of the crisis and had experienced excessive credit growth in the years leading up to the crisis. Their balance sheets had grown rapidly between 2005 and 2008 to an aggregate size of 10 times Iceland's GDP.[18] In 2008, the banks experienced funding problems and Iceland's Central Bank was not able to act as a lender of last resort due to the banks' outsized foreign assets and liabilities. As a result, the three banks collapsed in October 2008, triggering a major financial crisis. In the run-up to their collapse, all three banks had gained extensive exposures to a small group of connected businesses. But the country's existing prudential rules on large exposures to RPs were successfully bypassed, eluding internal control mechanisms, especially for the banks' largest shareholders. Based on an analysis by Iceland's Special Investigation Commission, the banks' largest borrowers were often their own owners: at least 20 percent of the banks' loans had been lent to only six groups of RPs – each of these parties had a significant ownership of at least 10 percent in one of the three banks. Recovery rates of these loans to RPs post-crisis were extremely low, between 4 and 6 percent.[19]

13. **Post-crisis, investigators concluded that the largest customer, Baugur Group, had been in violation of Iceland's legal provisions on related lending and large exposure limits for all three banks that collapsed in 2008.** In 2007, Baugur had acquired controlling shareholdings in Gitnir through their ownership of another company and in the three months following the acquisition, the bank's lending to Baugur Group and their RPs (i.e. to the bank's own controlling shareholder) had increased from 30 percent to nearly 90 percent of Gitnir's capital base, far beyond the legal limit on large exposures of 25 percent.[20] By the end of 2007, Baugur Group and 12 connected businesses had borrowed EUR 5.7 billion, more than half of the combined equity base of the three banks, based on the Special Investigation Commission's report. With these loans, Baugur took stakes in several famous Danish retail stores and engaged in a series of leveraged buyouts of well-known United Kingdom (UK) retail companies including Hamleys, Karen Millen, House of Fraser, and Goldsmiths.

14. **Two key reasons why Baugur's massive exposures went undetected and bypassed the legal limit of 25 percent[21] were (1) that the connection between the shareholder and the bank, or between the parent company of the shareholder and the bank, was not always transparent; and (2) an overly narrow implementation of Iceland's rules on connected lending.** In the run-up to Iceland's financial crisis, the burden of proof for establishing connectedness between bank customers or bank shareholders was on the Financial Supervisory Authority. This has since been reversed so that the burden of proof is on the party challenging an RPT designation, i.e. on the customer or shareholder. If connected lending could not be established, for example because a customer's shareholder structure was not transparent, then each party was allowed to borrow up to 25 percent of a bank's regulatory capital. In an extreme example of the failure to enforce the regulation on connected lending and large exposures,

18 Patrizia Baudino, Jon Thor Sturluson and Jean-Philippe Svoronos, FSI Crisis Management Series No 1, *The Banking Crisis in Iceland*, March 2020, Financial Stability Institute, Bank for International Settlements https://www.bis.org/fsi/fsicms1.pdf pg. 1, 4, 5, graph 1.

19 Baudino, Sturluson, and Svoronos (2020).

20 Johnsen, Gudrun. Bringing Down the Banking System: Lessons from Iceland. United Kingdom: Palgrave Macmillan, 2014. Pg.120-123, fig. 11.2. Based on: Source: Glitnir bank hf., SIC Report, Figure 52, Chapter 8, Volume 2, p. 137.

21 Per customer or group of connected customers

the supervisor was unable to declare loans held by the two largest shareholders of Landsbanki - who had purchased the bank together a few years prior - as “connected” and they were therefore considered as two separate parties for the regulation on connected lending.[22]

Ireland (2009)

15. **In Ireland, the Anglo-Irish Bank, the 3rd largest bank in the country, became troubled in 2009 after years of profligate lending to property developers.**[23] The Irish government nationalized the bank in 2009 when its financial soundness became threatened at a cost of around EUR 30 billion for Irish taxpayers.[24] Subsequent inquiries and external audits revealed serious loan irregularities and RPTs involving the Chairman, who had hidden loans granted to himself without informing shareholders. In just two years, loans from the bank linked to the chairman quadrupled.[25] Further, after the Chairman’s resignation, several more directors (including the managing director and the chief risk officer) also resigned over controversial personal loans.[26] While the bank had disclosed its “loans to directors” in its year-end financial statements, loans to the Chairman estimated at EUR 84 million at the end of fiscal year 2008 were transferred and kept hidden in a different entity, leading to a misrepresentation of the bank’s assets.[27]

Portugal (2014)

16. **Banco Espírito Santo (BES) went into resolution in 2014 after major problems caused, among others, by conflict of interest and RP lending, after the bank had been secretly lending money to its controlling shareholder.** BES, once the second-largest listed Portuguese bank, extended credit lines to a small bank in Panama owned by its holding company, Espírito Santo Financial Group, which used the money to buy debt issued by its parent company, Espírito Santo International. While BES financial reports noted it had credit exposure to ES Bank Panama, it did not detail that any of these loans were being used to lend to Espírito Santo International or other companies linked to the Espírito Santo family. The Espírito Santo-linked bank in Panama existed almost exclusively to buy up debt issued by Espírito Santo International and its subsidiaries, according to a report written by the administrators of BES.[28]

Ghana (2017)

17. **In Africa, cases of pervasive RPTs have also been reported.** In Ghana, for example, insider and RP transactions played an important role in what has been referred to as Ghana’s banking crisis.[29] In 2017, the Bank of Ghana withdrew the licenses of several banks as a response to poor corporate governance, false financial reporting, and insider dealings. According to a press release from the Bank of Ghana,[30] a number of legacy problems have plagued the banking sector including, but not limited to, macroeconomic factors, poor corporate governance, ineffective internal controls, weak risk management practices, as well as issues with RPTs, leading to a significant build-up of vulnerabilities in the sector. In the case of Unibank, shareholders, related, and connected parties had taken amounts totaling GHC 3.7 billion (USD 312 million) which were neither granted through the normal credit approval process nor reported as part of the bank’s loan

22 Report of the Special Investigation Commission, 12 April 2010. https://www.rna.is/eldri-nefndir/addragandi-og-orsakir-falls-islensku-bankanna-2008/skyrsla-nefndarinnar/english/

23 https://www.ft.com/content/af781e16-851f-3dc7-b872-c3ef7c8d36fe

24 After revelation of the scandal, the bank’s value dropped from a high of EUR 13 billion to a low of EUR 242 million: https://sevenpillarsinstitute.org/fall-anglo-irish-bank/

25 https://www.bbc.com/news/world-europe-40016676

26 The Fall of Anglo Irish Bank, Will Chu, Dec. 2014: https://sevenpillarsinstitute.org/fall-anglo-irish-bank/

27 https://www.reuters.com/article/us-angloirish/ex-anglo-irish-finance-director-charged-in-fraud-probe-idUSBRE86M0TW20120723

28 Miles Johnson & Peter Wise, “Banco Espírito Santo secretly lent funds to controlling shareholder”, September 11, 2014: https://www.ft.com/content/8e00b1d6-399c-11e4-93da-00144feabdc0

29 See https://www.bog.gov.gh/wp-content/uploads/2020/08/Speech-by-Dr.-Ernest-Addison-Governor-of-the-Bank-of-Ghana-at-the-2020-GIMPA-Biennial-Law-Conference-Series.pdf

30 https://www.bog.gov.gh/wp-content/uploads/2019/07/PRESS-RELEASE-Grand-Final-August-2018.pdf

portfolio. In addition, amounts totaling GHC 1.6 billion (USD 143 million) had been granted to shareholders, related, and connected parties in the form of loans and advances without due process and in breach of relevant provisions of the Banks and Specialized Deposit-Taking Institutions Act (Act 930). Altogether, shareholders, related, and connected parties of UniBank had taken out an amount of GHC 5.3 billion (USD 447 million) from the bank, constituting 75 percent of total assets of the bank. In the case of Royal Bank, an on-site examination conducted by the Bank of Ghana in 2018 revealed that transactions totaling GHC 161.92 million (USD 13.7 million) were entered into with the bank's shareholders and related and connected parties, structured to circumvent single obligor limits, conceal RP exposure limits, and overstate the capital position of the bank for the purpose of complying with the capital adequacy requirement. In the case of Premium Bank Limited, Bank of Ghana investigations revealed that 37.2 percent of the bank's loans had been granted to RPs. These loans were more than the bank's equity (above the regulatory limit of 10 percent equity). Also, outstanding loans to RPs were wrongly classified by the bank as "investments".[31]

18. **Aside from the above examples of how the misuse of RPTs can result in financial ruin for the financial institutions involved and cause system-wide banking crises with severe impacts on taxpayers and public finances, RPTs can also present risks to financial integrity, including facilitation of corruption, money laundering, tax evasion, and other financial crimes.** As the example below illustrates, bank insiders in positions of control can use their influence to compromise the bank's internal compliance and anti-money laundering controls so that connected parties can channel illicit funds through the bank.

Odebrecht and Meinl Bank (2010)

19. **Bank Meinl played a crucial role in the movement of bribes paid by Odebrecht, a construction company, uncovered as part of the lava jato (car wash) investigation.**[32] Around 2006, Odebrecht established the Division of Structured Operations (DSO), a standalone division within the company which was used to pay bribes. It managed and distributed funds that Odebrecht never recorded on its balance sheet. These funds were funneled to a series of offshore entities not included on Odebrecht's balance sheet as related entities. These entities were established and managed at the DSO's direction by individuals who were compensated for opening and, in some cases, operating these offshore entities to conceal and disguise bribe payments made to, or for the benefit of, foreign officials, foreign political parties, foreign political party officials, and foreign political candidates in various countries. DSO also used banks with distinct features that would aid in the scheme. To ensure the cooperation of these banks, it frequently paid remuneration fees and higher rates to the banking institutions, and a percentage of each illicit transaction to certain complicit bank executives, counting on the collusion of the favored banks and their executives to conduct the transfers between accounts and relying on the use of fictitious contracts to backstop the transactions and bypass compliance inquiries. As part of this scheme, members of the DSO purchased 51 percent of the small, largely inactive Antiguan branch of Bank Meinl in late 2010, allowing senior politicians from multiple countries to receive bribe payments and open bank accounts without the risk of raising attention, the owners making sure that no compliance issues were raised. DSO also moved corporate accounts of offshore entities connected to Odebrecht over to Meinl Bank's Antigua branch, which served as an important nexus in the bribery scheme.

31 https://ghreceiverships.com/revocation-of-the-license-of-premium-bank-limited/; see also Ghanaian Banking Crisis of 2017-2019 and Related Party Transactions, by Anthony Q.Q. Aboagye, African Journal of Management Research, vol. 27, N1, 01-17, 2022: https://www.ajol.info/index.php/ajmr/article/view/220132

32 This write-up is mainly based on a 2016 plea agreement between Odebrecht and the US authorities, and a Bloomberg article. *United States v. Odebrecht* S.A. at https://www.justice.gov/opa/press-release/file/919916/download and DOJ press release, December 21, 2016, "Odebrecht and Braskem Plead Guilty and Agree to Pay at Least $3.5 Billion in Global Penalties to Resolve Largest Foreign Bribery Case in History" at https://www.justice.gov/opa/pr/odebrecht-and-braskem-plead-guilty-and-agree-pay-least-35-billion-global-penalties-resolve; See also Bloomberg Businessweek, No One Has Ever Made a Corruption Machine Like This One, By Michael Smith, Sabrina Valle and Blake Schmidt June 8, 2017 at https://www.bloomberg.com/news/features/2017-06-08/no-one-has-ever-made-a-corruption-machine-like-this-one).

Many of these transactions were layered through multiple levels of offshore entities and bank accounts throughout the world. Once they were up and running, at least 33 banks fed Odebrecht's money into at least 71 different accounts at Meinl Bank. Aside from solving Odebrecht's banking needs, DSO also stood to gain financially, gaining a 2 percent commission on all Odebrecht funds funneled through the bank. In 2019, the European Central Bank (ECB) revoked the banking license of Meinl Bank, which was rebranded as Anglo-Austrian Bank after the allegations became public, amid ongoing concerns over compliance failures and allegations of money laundering.[33]

Section 2. Motivations behind Transactions with Related Parties: from bona fide to criminal

20. **RPTs may be motivated by reasonable intentions. Transactions between banks and their RPs have historically been a common practice in finance.** Extending loans to RPs was a key feature of the early economic histories of many developed economies during periods of rapid economic growth, including in the United States during the nineteenth century, in Germany, and in Japan.[34]

21. **In fact, there are several motivations behind transactions between a bank and its RPs, ranging from business needs to strategic considerations.** For example, banks may engage in intra-group transactions (e.g. with affiliates or subsidiaries) to leverage shared resources, expertise, and capabilities. This can lead to cost savings and the development of specialized products or services that benefit all parties involved. In the same vein, transactions between RPs within a banking group or a conglomerate may be part of a larger strategic plan, such as a merger or acquisition. Operations with RPs may also be used to manage risks, for instance by transferring certain assets or liabilities to a RP to mitigate specific risks or optimize capital allocation or by providing guarantees or letters of credit to subsidiaries or affiliates. Banks may engage in transactions with RPs to access specialized services or expertise not available internally or in the open market. For instance, a bank may utilize the services of a related entity to obtain specialized technology solutions, risk assessment capabilities, or legal expertise. This can provide a competitive advantage and enhance the bank's ability to meet customer needs. Often, transactions between a bank and its RPs may be motivated by personal relationships or family ties.

22. **But RPTs can also be driven by malignant intentions.** While very few countries prohibit them, RPTs still raise concerns because of potential conflicts of interest, insider trading, or other unethical or illegal behavior. There is no grey area here. RPTs are either legitimate, provided they are done on an arm's length basis and other conditions are met, or they are harmful, when carried out in violation of international standards. Of course, there can be different degrees in the damage caused but the general principle is that RPTs carried out outside the rules (whatever the motivations which guide them) must arouse the greatest caution. The examples in **Section 1** show the types of consequences transactions with RPs can have with significant ramifications on the economy and taxpayers, and thus why regulations and oversight over such transactions are needed. While the examples of RPTs above describe a variety of highly different scenarios, with different underlying motivations, they all have something in common: their toxicity.

23. **Most RPTs are not abusive and all abusive RPTs do not necessarily lead to the ruin of the bank; however, they erode the income of the institution, taint its reputation, and ultimately harm its shareholders and depositors.** Even seemingly "benign" operations have an impact. This may, for example, be the provision of services or goods

33 The bank's ex-CEO and another senior bank executive were charged with money laundering through the U.S. financial system by prosecutors in the Eastern District of New York in 2021. https://www.justice.gov/usao-edny/pr/two-individuals-indicted-money-laundering-related-odebrecht-bribery-and-fraud-scheme.

34 For the United States, see: Lamoreaux, N. 1994. Insider Lending: Banks, Personal Connections, and Economic Development in Industrial New England. Cambridge, England: Cambridge University Press.

by the counterpart at onerous terms to the bank. While this will not threaten the financial soundness of the institution, it will certainly erode revenue and shareholders' returns. Another example is the provision of liquidity by the bank to a financially distressed related conglomerate of companies in need of new financing that it would not be able to obtain elsewhere. The extension of liquidity (not just by banks or financial institutions) to RPs which are operational firms or holding companies in times of (temporary) financial distress, is qualified as "corporate propping".

24. **Even if some find it advantageous, corporate propping remains a questionable practice.** In the current literature, there is an alternative perspective on corporate propping, which views these types of transactions as ultimately providing a solution where normal market conditions don't provide for one. On this view (sometimes referred to as the "information view"), related lending can under certain circumstances have positive impacts, at least provisionally, for both the borrower and the lender. The idea is that related lending allows banks to better assess ex-ante risks of related borrowers as they have more information and a better understanding of the borrower's creditworthiness than a non-related bank would have. Where under normal conditions an operational firm starved for credit would have gone bankrupt, according to this theory, because of its improved information position, the bank can do a deal, generating business for itself and ensuring the survival of the related borrower- a net gain for both sides.[35] Nevertheless, corporate propping remains a questionable practice given the inherent risks of financing distressed entities.

25. **The pursuit of gains, undue advantage, and enrichment remain the primary motivations behind abusive RPTs.** All the examples described in section 1 perfectly illustrate this – blatant attempts to appropriate the assets of the banks for private use, serving no economic purpose for the banks involved. Here, RPTs involve an abuse of power by bank insiders to make fraudulent or otherwise disingenuous loans, often on non-market terms, which benefit the borrower and can harm or bankrupt the lender. It is important to distinguish between the different roles that a bank can play within this criminal realm, as illustrated by the earlier examples. In the Moldovan case (and the Snoras example) the assets from Banca de Economii, Banca Sociala, and UNIBANK were themselves the target of the operation – it is those funds which the wrongdoers aimed to misappropriate. In the *Lava Jato* investigation, Meinl Bank acted as a facilitator or co-conspirator of the scheme: the bank facilitated the entire operation, and received a significant fee for its services, but the bank's own assets were never the target of the fraudulent scheme. Though there is similarity in "relatedness" in that in both examples both parties to the respective transactions were controlled by the same group of individuals, the transactions were fundamentally different in nature, with different consequences. The movement of funds from the Moldovan banks crucially affected the bank's financial stability and led directly to their bankruptcy, which in turn affected a wider group of actors, notably depositors, and ultimately the economy as a whole. The facilitation of the bribery scheme by Meinl Bank, by evading anti-money laundering/countering the financing of terrorism controls, or indeed its role in facilitating the movement of Snoras funds, left Meinl's capital and liquidity metrics unaffected, and did not result in the impairment of its assets. It was only subsequent action by government authorities for breach of anti-money laundering rules that affected it, and thus ultimately Meinl's viability as a bank.

26. **In summary, while there may be some benefits to RPTs, the risks and potential drawbacks are significant and should be carefully considered before engaging in this practice.** As discussed in this paper, RPTs carry several types of risks, including conflicts of interest, financial losses, reputational and legal risks, lack of transparency, and concentration risks. The wider characteristics of the economy and jurisdiction in which RPTs take place, and the quality and structure of the parties to the transaction, are also important factors at play. A review of empirical studies suggests that the inherent risks and economic impacts of RPTs are dependent on, among other factors:

35 See Balyuk, Tetyana, An Empirical Study of Related-Party Lending (September 30, 2014). Available at SSRN: https://ssrn.com/abstract=2803750

- the broader institutional context, especially the strength of the rule of law, corporate governance, risk management, and the quality and independence of supervision;
- the structure and nature of ownership of the bank involved and type of controlling shareholders (e.g. whether they are state-owned, family-owned, owned by a politically exposed person (PEP), owned by a non-financial firm, etc.);
- the type of counterpart that is benefitting from the RPT (e.g. operational company, holding company, shell company), and their financial health;
- the size of the transaction(s), relative to the bank's overall assets.

CHAPTER 2

THE ROOT CAUSES OF RPT CRISES AND THE RISK OF RESURGENCE

In light of the country cases described previously, this chapter discusses the root causes of the RPT problem, ranging from weak risk management and governance and a poor culture of ethics, to gaps in regulatory and statutory frameworks and supervision. It considers how and why some of these aspects have escaped authorities' attention. This chapter also provides an overview of the outcomes of the evaluations of international standards on prudential supervision performed by the WB and the IMF as well as other lessons learned from fieldwork, raising concerns about the prospect of RPT problems going forward.

Section 1. The Underlying Elements of of Problems arising from Transactions with Related Parties

27. **Problems arising from transactions with RPs have multiple sources.** The objective of this section is not to provide an exhaustive list of all the root causes nor to provide a classification according to their respective weight or gravity but rather to give an overview of the features most commonly observed, especially in countries that have experienced acute RPT problems.

28. **Different definitions of RPTs can coexist, which may be confusing.** Indeed, there are often different definitions of RPTs within a single jurisdiction, stemming from accounting, prudential, or other rules and because they serve various purposes (e.g. prudential, disclosure, risk management goals), that on occasion can conflict with each other. In addition, the definitions of RPTs is often limited to lending operations, including write-offs (albeit not always), without considering other financial or commercial dealings such as service contracts, asset purchases and sales, construction contracts, lease agreements, derivative transactions, or deposits from RPs.

29. **Legal definitions of RPs are often overly narrow and fail to capture all the actors able to extract private benefits from banks: senior managers, key staff, their direct and related interests, and their close family members are sometimes not included.**[36] The definition of close family member is frequently restricted to wife, husband, father, mother, son, daughter, brother, sister, or other dependent person.[37] The experience of some jurisdictions with material RP problems shows that while the banks' immediate RPs, such as managers or controlling shareholders, were mostly known to the authorities, numerous borrowing entities that were de facto connected to these RPs were not reported as such.

30. **Weak bank governance systems are at the center of the problem.** Abusive and prejudicial RPTs are a corporate governance issue as they represent failures of the whole governance structure of the banks: i) major shareholders or beneficial owners exercising undue influence and seeking personal gain; ii) board members failing to fulfill their duties of care and loyalty towards the bank and depositors and not effectively performing their oversight function, specifically that corporate or business resources of the bank are not misappropriated or misapplied; iii) lack of independence within critical control structures (board, internal audit, risk management and compliance); iv) lack of transparency and disclosure; and v) weak external audit.

31. **In some jurisdictions, mismanagement of boards has been a contributing factor, with significant power in the hands of a CEO, at the expense of the board.** In several banks that collapsed from abusive RPT practices, important decision-making responsibilities were concentrated in the CEO position who could act without requiring approval from the Board. Furthermore, boards of several banks were not fully constituted; some did not have the requisite number of members, including independent directors, and some board members did not seek or receive approval from the supervisor. As a result, many banks

36 For example Ireland's "connected person" definition refers to: (a) spouse, domestic partner, civil partner, or child (whether natural or adopted) of a person; (b) two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others; or (c) two or more natural or legal persons between whom there is no relationship of control as set out in point (b) but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties. Other jurisdictions added the following elements into their RP definitions or otherwise allowed the supervisor to consider the following as RPs : (i) any person or class of persons whose direct or indirect interest in, or relationship with, the bank or its RPs might reasonably be expected to affect the bank's judgment in respect of a transaction (Canada); (ii) parties that are economically dependent on the bank or its RPs, in that one party's failure could result in the failure of the other (Türkiye); (iii) any person through which 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).

37 In accounting, International Accounting Standard (IAS) 24 defines a RP in broad terms and refers to individuals and firms. Physical persons are deemed to be RPs when they control or jointly with other partners control (ability to affect his variable returns from the firm or subsidiary), have significant influence (power to participate in financial and operating policy decisions), or are members of the key management personnel (persons who have responsibility for planning, directing, and controlling the activities of the firm, including board members); in addition, close members of the family (who may be expected to influence, or be influenced, in their dealings with the firm) are also considered RPs (children and spouse or domestic partner, children of the spouse or domestic partner, and dependents of both). A transaction is defined as a transfer of resources, services, or obligation regardless of whether a price is charged.

were operating without full boards or with board members that were not vetted by the competent authorities, allowing further concentration of decision-making power in the CEO.

32. **Gaps in the regulatory framework could facilitate and bias board actions to fulfill the owners' interests rather than to act in the best interest of the bank and depositors.** Countries that experienced acute RPT problems generally had an inadequate legal framework that allowed the role of bank boards to be determined by each bank's board charter rather than enumerating the boards' responsibilities in law or in regulation, as per BCP #14 on corporate governance.

33. **Supervisory boards have sometimes been diminished in banks with a two-tier governance system,** i.e., boards become confined to a policy approving function instead of playing a leadership role by setting and monitoring overall strategy and risk appetite, overseeing management, and (dis)approving or overseeing RPTs.[38]

34. **Lack of ethics at the very top of the organization has been linked to RPT problems.** Closely related to governance, ethics are at the core of the corporate culture and without a sound risk culture, organizations are at risk. Ethical behavior means acting in ways that are consistent with what society, individuals, and businesses generally accept as good values, which include inter alia honesty, integrity, fairness, due care, and diligence. That is why the overall corporate culture and values is assessed to be the most important influence on ethical behavior at every level of a corporation.[39] A corporation's culture starts at the top with the board of directors, CEO, and other senior managers as well as major shareholders. In many cases of abusive RPTs, executive leaders and shareholders prioritized their own interests over those of depositors. They intentionally hid loans granted to themselves or to their closest associates, engineered accounting manipulations, and confused auditors and supervisors by misstating financial information.

35. **A deficient licensing and approval process can also contribute to abusive RPT practices.** This has been the case in several transition countries, where weaknesses in licensing regimes bred non-transparent ownership structures, enabling the emergence of banks that were poorly managed or owned by PEPs that, in some cases, set the stage for costly financial crises.[40] Having in place strong licensing requirements is therefore a fundamental pre-condition for a sound and safe banking sector. The BCBS requires the supervisory authority to establish and apply 'fit and proper' and 'suitability' standards to a bank's major shareholder, including the beneficial owners and those persons or entities that "may exert significant influence" over the new bank.[41] In addition, the supervisory (or licensing) authority should determine that the applicant for a new bank charter demonstrates that "an appropriate system of corporate governance, risk management, and internal controls, including those related to the detection and prevention of criminal activities, (…)" will be in place. This requires the applicant to demonstrate that it will have "in place" adequate governance and internal controls to address RPTs and "criminal activities".

36. **Due diligence and fit and proper assessments during the licensing process and/or significant transfer of ownership have been inadequate or absent.** RPT problems have often involved the entry of applicants with limited relevant banking experience, unknown track records, and thus ultimately, deficient risk management systems. This holds equally for an established bank, when significant ownership is transferred and capital is concentrated in the hands of a small group of individuals willing to engage in aggressive business strategies, due to

38 A two-tier governance structure should recognize the roles of both supervisory and management boards. Different structures have different advantages and drawbacks; it is not always the case that banks with a one-tier governance structure are better in terms of abusive RPTs.

39 Nick Price, Ethical Behavior for Board Members Is Culturally Driven, August 9, 2017: https://www.boardeffect.com/blog/ethical-behavior-board-members-culturally-driven/

40 Establishing a fit-for-purpose banking law in Uzbekistan, Miquel Dijkman and Eva Gutierrez, December 03, 2019: https://blogs.worldbank.org/psd/establishing-fit-purpose-banking-law-uzbekistan.

41 BCP #5: Licensing Criteria, provides: "*The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of board members and senior management of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). Where the proposed owner or parent organization is a foreign bank, the prior consent of its home supervisor is obtained.*"

a lack of supervisory attention.[42] As a result, key oversight and control positions within the bank itself (e.g. supervisory board, management board, and internal control functions) de facto all fall under the control of the major shareholder. Overlapping responsibilities between shareholders, non-executive board, and executive board create an environment allowing owners to directly influence the bank's daily operations for their own interest. And gaps in the regulatory and supervisory frameworks can contribute to worsening the consequences of this problem.

37. **Lack of bank shareholder transparency is often at the root of abusive RPTs, and supervisors often face significant challenges in trying to monitor large exposures of banks, keeping track of who actually owns a bank and to whom the bank is lending.** When reliable information on company ownership does not exist, strict laws on RPTs do not necessarily provide protection. Opaque changes in bank ownership, e.g., by acquiring ownership piecemeal, in transactions just under thresholds that require prior approval by or notification to the supervisors, or by hiding beneficial owners behind multiple layers of foreign-registered shell companies, cannot be properly monitored by the supervisor and can ultimately result in bank failure. For this reason, several countries that have experienced large scale RPT-related banking or financial crises, e.g. Iceland, Moldova, and Ukraine, have enacted laws that reverse the burden of proof for demonstrating "relatedness" between two parties, or a lack thereof, to the bank customer or shareholder presumed to be connected.

38. **Closely related to the above, the use of nominee directors, nominee shareholders, foreign trusts, and complex corporate structures obscuring beneficial ownership are among the most difficult challenges for all actors involved – banks, audit firms, and supervisors - tasked with identifying relatedness.**

- A nominee is an individual who holds a position in a company, e.g., a company director or a shareholder, but who exercises the functions on behalf of, or on the instructions of, another individual (the nominator) who has a more substantive claim to control and/or ownership of the company.[43] While there are many legitimate and innocuous uses of nominees, these types of arrangements are one of the most common devices for hiding the identity of those controlling shell companies. A recent WB study, *Signatures for Sale*, analyzed data from a global "mystery shopping" exercise that revealed that nominee services are often explicitly marketed to clients shopping for shell companies as a device to keep the identity of the beneficial owner off the public record.[44] In such arrangements, the nominee acts simply as a front with no substantive connection with the company.
- While special purpose vehicles and other corporate structures play a vital role in the efficient operation of global financial markets,[45] absent rigorous transparency rules, they can also be abused with significant consequences.

These mechanisms can be used to conceal connections between parties, thus preventing supervisors (or bank management, board members, and compliance officers) from mapping all inter-related exposures and understanding the overall exposure of the bank to all its affiliated parties, including concentration risks to a client or a group of connected clients. Where beneficial ownership of shareholders or bank clients cannot be established, affiliated companies and relations cannot be determined – and this leads to potentially risky RPTs going unnoticed and being approved as ostensibly "normal" transactions. Representatives from all relevant sectors - supervisors, banks, and audit firms - interviewed for this report frequently

42 For example, the absence of an authority responsible for overseeing the registration and transfer of shares in listed banks (usually a national commission for financial markets).

43 See new definitions of nominee shareholder and nominee director in the Financial Action Task Force (FATF) Glossary (www.fatf-gafi.org/recommendations.html) and chapter 15 in FATF (2023), Guidance on Beneficial Ownership for Legal Persons, FATF, Paris, http://www.fatf-gafi.org/publications/FATFrecommendations/guidance-beneficial-ownership-legalpersons.html

44 D. Nielson, J. Sharman, *Signatures for Sale: How Nominee Services for Shell Companies Are Abused to Conceal Beneficial Owners*, Stolen Asset Recovery Initiative, World Bank Group, Washington, D.C. 2022 https://star.worldbank.org/publications/signatures-sale-how-nominee-services-shell-companies-are-abused-conceal-beneficial

45 PwC, The Next Chapter Creating an Understanding of Special Purpose Vehicles: https://www.pwc.com/gx/en/banking-capital-markets/publications/assets/pdf/next-chapter-creating-understanding-of-spvs.pdf

highlighted challenges in verifying information on bank shareholders and clients, and several described large numbers of undisclosed nominees in some state corporate registries and the use of foreign trusts in company ownership structures as particularly problematic.

39. **Lack of bank shareholder transparency and lack of availability of high-quality information on legal entities are particularly concerning when PEPs secretly own or control banks or benefit from transactions.** The BCBS recognized the risks posed by PEPs explaining that "it is clearly undesirable, unethical and incompatible with the fit and proper conduct of banking operations to accept or maintain a business relationship, if the bank knows or must assume that the funds derive from corruption or misuse of public assets."[46] Since 2003, the global anti-money laundering standard-setter, the FATF requires financial institutions to identify PEPs (as their customers or as their beneficial owners), establish their source of wealth, and apply enhanced due diligence measures and ongoing relationship monitoring. However, neither banks nor the supervisor can ascertain whether PEPs are involved in a transaction if beneficial ownership of the legal entities involved cannot be established. Several banks interviewed for this paper noted that given the challenges related to beneficial ownership transparency, identification of PEPs in their list of RPs creates uncertainty and imposes real costs on the bank.

40. **Corporate affiliations that create potential conflicts of interest are not always recognized by supervisors.** Major acquisitions or investments by a bank, especially when it comes to acquiring an interest or controlling stake in non-banking activities, should be subject to supervisory approval with prudential conditions where necessary. Some of the examples encountered demonstrated how bank acquisition of industrial businesses generated situations of conflict of interest and abusive RPTs. Even advanced bank supervisors have missed RPTs that ultimately resulted in a bank's collapse due to failing to examine possible conflict of interest situations or to establish "relatedness" between parties.

41. **Political pressure or market interference have long been among the biggest challenges confronting supervisors.** A supervisor may have declined to act due to direct or indirect political pressure. Where the political will to enforce prudential standards is compromised, supervision is unlikely to succeed in keeping the banking system sound. There are a few examples, notably in Eastern Europe, where supervisory staff were harassed by vested interests and in extreme cases threatened–sometimes physically–by politically connected individuals or groups of investors. Closely related to the above, the underlying factors preventing supervisors from taking action can be seen as a lack of supervisory independence and inadequate legal protection. As a result, supervision of RPTs is superficial.

42. **There are other circumstances where the failure of the supervisor to act on RPTs has contributed to broader banking problems (discussed further in the next section).** This may be due to a lack of powers or to gaps in laws and regulations that are specific to the RP framework. Issues may include, for example, too high or even non-existent limits on RPTs, and lack of supervisory discretion in applying the RP definition on a case-by-case basis and deciding when a RPT is made at preferential terms.

43. **Insufficient supervisory resources and skills, as well as inadequate governance and decision-making processes at the supervisory levels, could also adversely impact effective early intervention and timely corrective action.**

44. **Lastly, in certain jurisdictions, the lack of a professional and independent judiciary may be a contributing factor to the execution of abusive RPTs.** When the judiciary lacks the requisite financial sector expertise, for instance, it may not recognize a supervisor's professional judgment on what constitutes "relatedness" between parties or on the nominal nature of a professed beneficial owner. There are numerous examples in which a supervisor's informed decision was overturned or where the judiciary significantly curtailed the powers of the supervisor to address changes in control, require disclosure of beneficial owners, and take other actions. Political pressure and widespread corruption may exacerbate challenges to supervisory action.

46 BCBS, Customer Due Diligence for Banks, Bank for International Settlements, October 2001, para. 43.

Section 2. Lessons learned from WB and IMF Financial Sector Assessment Programs

45. **The FSAP is a comprehensive and in-depth analysis of a country's financial sector.** It brings together WB and IMF expertise to assess the resilience of the financial sector, the quality of regulatory and supervisory frameworks, and the capacity to manage/resolve financial crises and to identify opportunities for the financial sector to better meet the needs of the real economy and a country's population. 350 assessments have been completed over the past twenty years, with 146 countries covered individually at least once across all regions.[47]

46. **As part of the FSAP, WB and IMF staff review the quality of bank supervision in countries and evaluate the ability of central banks, regulators and supervisors, policymakers, backstops, and financial safety nets to respond effectively in case of systemic stress.** To this end, both institutions produce "Reports on the Observance of Standards and Codes". These aim to promote greater financial stability, both domestically and internationally, through the development, dissemination, adoption, and implementation of international standards and codes in twelve policy areas, including banking regulation and supervision (compliance with the BCPs).[48]

47. **An analysis of the degree of compliance with BCP #20 in a sample of 47 countries,[49] reveals major flaws in domestic legal regimes governing transactions with RPs.** Out of the 47 countries, about 20 countries were found materially non-compliant,[50] and two countries were found non-compliant.[51] In extreme cases, laws on RPTs were found not to have been enforced at all and/or the supervisor had not conducted any specific controls in this area. Assessors also found that the types of transactions giving rise to RP exposures were not well defined in regulations. The most common problem was found to be a non-comprehensive definition of RPs that omitted certain groups with which banks had commercial relationships (BCP #20, Essential Criteria (EC) #1). For example, definitions did not cover:

- All close family members of a related person or the companies related to him/her or other direct and related interests;[52]
- indirect ownership interests;
- banks' members of the board, senior management, or key staff;
- subsidiaries of institutions or affiliated companies;
- non-resident subsidiaries or affiliates, etc.

48. **Wide variations were found in the definitions of RPs, along with some good practice.** The experience of some jurisdictions with material related-party problems shows that while the banks' immediate RPs, such as managers or controlling shareholders, were

47 FSAP assessments are the joint responsibility of the WB and the IMF in developing economies and emerging markets and of the IMF alone in advanced economies.

48 The other areas are Securities and Insurance Supervision, Data Dissemination, Fiscal Policy Transparency, Monetary and Financial Policy Transparency, Crisis Resolution and Deposit Insurance, Insolvency and Creditor Rights, Corporate Governance, Accounting and Auditing, and Financial Market Infrastructure.

49 The analysis used assessments of compliance with BCPs prepared by the IMF and WB for the period of 2012-2019.

50 According to the Basel methodology (2012), a country is considered materially non-compliant with a Principle whenever there are severe shortcomings, despite the existence of formal rules, regulations, and procedures, and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance.

51 A country is considered non-compliant with a principle if there has been no substantive implementation of the BCP, several EC are not complied with, or supervision is manifestly ineffective.

52 In that regard, an FSAP carried out in a lower middle-income country in South Asia showed important flaws. First, the definition of RP was too narrow as it did not capture all the actors in principle able to extract private benefits from banks. Senior managers, key staff and their "close family members", as well as their direct business interests were not included. Second, the concept of "close family members" was restricted to "wife, husband, father, mother, son, daughter, brother and sister and other person dependents on the directors". However, in a business environment characterized by concentrated family ownership, it would have been appropriate to broaden the definition of "close family member" to complex inter-generational relationships (cousins, in-law, aunts, uncles, or equivalent, and grandparents) able to tunnel funds by corporate insiders. This would have provided the supervisors with additional discretion to be exerted on a case-by-case basis.

mostly known to the authorities, numerous borrowing entities that were de facto connected to these RPs were not reported as such.

49. **In many countries it was difficult for a supervisor and banks to define a clear framework for RPTs.** Often supervisors had no power to exercise discretion in applying the definition of RPs on a case-by-case basis. Further, while lending was usually covered by the definition of RPTs, certain transactions were excluded: e.g. guarantees or letters of credits, lease contracts, derivative transactions, deposits from the RP, debt securities, service contracts, as well as sales and purchase of assets. In an extreme case, RPs were not defined in law and definitions were scattered in different legal texts that appeared contradictory. In some countries, there were no explicit requirements for transactions to be undertaken at arm's length[53] or these requirements did not apply for certain transactions (e.g. deposits).

50. **The assessments identified issues with board approval processes.** Some countries had no formal requirement of prior approval by the bank's board of RPTs exceeding specific amounts (BCP #20, EC #3), or for approval of write-offs of RP exposures.[54] Conflicts of interest during both the approval process (BCP #20, EC #3) and when granting and managing the transactions (EC #4) were also found.

51. **FSAPs also revealed flaws in setting prudential limits on aggregate exposure to all RPs.** It was very often the case that a supervisor had no power to set up limits on exposures to RPTs or deduct such exposures from capital when assessing capital adequacy.[55] On a few occasions, the limits did not apply to foreign bank branches, wider conglomerates, or specific groups of borrowers (e.g. staff). Moreover, some limits on RP exposures were too loose and not consistent with international standards.[56]

52. **Finally, in some countries, supervisors did not control whether banks had policies and processes on RPTs including via independent review processes (BCP #20, EC #6).** In that regard, several BCP assessments showed that exposures to RPTs were not part of banks' internal reviews and some banks omitted reporting insider loans. In the same vein, supervisors did not obtain and monitor information on aggregate exposures to RPTs (BCP #20, EC #7) and even where a supervisor could identify RPTs, it did not always have authority to discipline a bank or impose penalties on involved parties when rules were breached.

53. **The FSAP review revealed that BCP #20 had the second lowest level of compliance among the 29 BCPs (see Chart 2 on the next page).** It is also worth noting the low level of compliance with other key BCPs shown in **Chart 2**, such as independence, resources and legal protection for supervisors, corrective and sanctioning powers, and corporate governance. This illustrates continued weaknesses in many countries' banking supervisory and regulatory regimes which, if not addressed, further increase the prospect of future RPT problems.

Section 3. Other Lessons Learned from Fieldwork

54. **Fieldwork revealed a range of areas in need of reform. The team visited a sample of countries for this paper, both developed and emerging, in the European Union (EU) and Eastern Europe, to collect further insights on RPTs from a wide range of domestic public and private counterparts, banks, external auditors, and supervisors, as well as from supra-national bodies, the European Banking Authority (EBA) and ECB.** Findings show significant

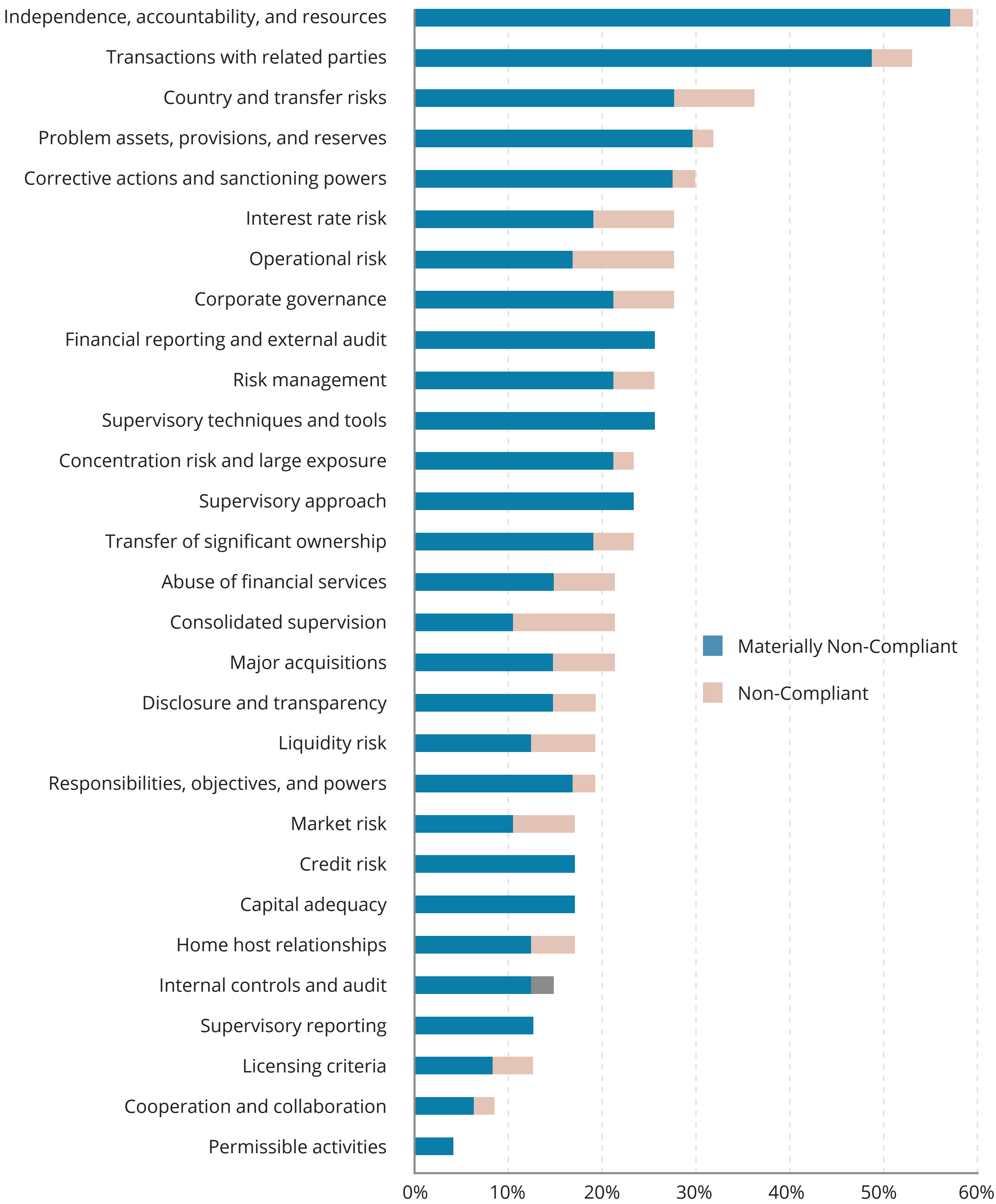
53 Mentioned in six reports reviewed by the authors.

54 Mentioned in eight reports.

55 Mentioned in nine reports.

56 BCP #20 stipulates that supervisors have the power to set limits for exposures to RPs: When these limits are set on an aggregate basis they are at least as strict as those for single counterparties or groups of connected parties i.e. 25 percent of Tier 1 capital as per the standard on large exposures (BCP #19).

Chart 2. Compliance with BCPs identified in FSAPs (% of countries)



Source: WB and IMF

divergence in supervisory and professional practices as well as loopholes in existing laws and regulations, calling for reforms. Good practices were also found.

Lack of harmonization in the EU

55. **There is no directly applicable EU-wide framework for exposures to RPs in the euro area.**[57] Definitions of RPs differ widely across Single Supervisory Mechanism (SSM) Member States. Also, since there are no directly applicable acts of Union law (EU Decisions or Regulations) in relation to RPTs, the ECB cannot apply sanctions for infringement of the RPT framework but can only require national competent authorities to open proceedings. While ECB Joint Supervisory Teams actively discuss RP risk in individual cases, there is no common approach to the supervision of RP risk for significant institutions in the SSM.[58]

56. **Significant divergence in practices were observed in terms of frequency and details of reporting of RPTs.** Only a few jurisdictions in the euro area (e.g. Ireland[59] and Spain[60]) require additional reporting, beyond the EU harmonized financial reporting standard, to provide the supervisor with more meaningful information on RPTs (name of the borrower, amount of the loans, collateral etc.). Some other countries compile information on an aggregated basis only.

57. **The degree of harmonization in the euro area around policies governing RPT is minimal, since it is based on Directives[61] which are not directly applicable in Member States.** Their transposition into national law is often unduly delayed and the content of the Directives may be selectively included. Moreover, EBA guidelines[62] are not binding since they follow a "comply or explain" approach. Substantial divergences among Member States were found in prudential regimes for loans to bank board members. There were no limits in several visited countries, except for large exposures. When in place, limits vary widely among SSM Member States: in Ireland for example, these exposures must be contained up to 0.5 percent of the bank's own funds (5 percent for aggregated exposures) while in Italy, they could reach up to 5 percent (consolidated level) or 20 percent (individual level) of the bank's own funds.

58. **Measures to counter the risk of using RPTs to inflate capital were an example of good practice.** In the euro area, there is the presumption that loans granted to RPs in conjunction with a capital increase are used to fund the capital increase itself and this might lead to the ineligibility of capital instruments as common equity.[63] To mitigate the risks, there is an inversion of the burden of the proof in the EU whereby the bank must convince the supervisor that loans were not used by a RP to buy shares of the bank, hence inflating the capital.[64]

57 See IMF Country Report No. 18/233, Detailed Assessment of Observance of Basel Core Principles for Effective Banking Supervision for the euro area, July 2018: https://www.imf.org/en/Publications/CR/Issues/2018/07/19/Euro-Area-Policies-Financial-Sector-Assessment-Program-Technical-Note-Detailed-Assessment-of-46107

58 ibid.

59 https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/credit-institutions/reporting-requirements/notes-on-compilation.pdf?sfvrsn=20

60 In Spain, credit institutions must provide the competent authority with a list of board members and their RPs, general directors, and persons holding similar positions in the credit institution, to whom credit, loans, and guarantees have been granted, on a six-monthly basis. The list states the amounts granted in the period and the outstanding balances on the closing date of the period, the ID card number or tax ID number of the borrower, and the position they hold. In case of board members, the list also states if they are executive or non-executive members and, in case of RPs to board members, the personal or company relationship. Additionally, credit institutions must document loans to members of the board and their RPs and hold certain data on those loans available to competent authorities upon request.

61 Among them, Directive (EU) 2019/978 of EU Parliament and Council of 20 May 2019 (Capital Requirements Directive (CRD) V) which amended Art. 88 (governance arrangement) of Directive (EU) 2013/36/EU (CRD IV) and requires Member States to ensure that "*data on loans to member of the management body and their related parties are properly documented and made available to competent authority upon request*".

62 See, for example, EBA Guidelines on Internal Governance (EBA/GL/2021/5) which set forth supervisory expectations on "*conflict of interest policy in the context of loans and other transactions with members of the management body and their related parties*".

63 See Basel framework (par. 10.8 n. 11) and Regulation EU n. 575/2013 CRR of the European Parliament and of the Council of 26th June 2013 art. 28, par. 1 let. b

64 Art 8. Commission Delegated Act (EU) No 241/2014 of 7 January 2014

Concept of qualifying holding & influence

59. **It is not always clear who should be considered a RP. In many countries, a shareholder with 10 percent (or more) of the capital or of the voting rights (qualifying holder) is considered a RP.**[65] The principle is that 10 percent of equity or voting rights allows the shareholder to exert influence on a bank's decision-making process. However, country examples show that a lower percentage of equity or voting rights might lead to the same outcome, especially in listed banks where equity is fragmented among a multitude of shareholders. As a result, shareholders with less than 10 percent of capital but acting in concert can still exercise influence and become RPs while being unnoticed by the supervisor. This has been a challenge in countries that suffered from excessive RPT problems. Therefore, supervisors should be able to exercise discretion in applying the RP definition on a case-by-case basis (BCP #20, EC #1).

Lack of reliable information on beneficial ownership

60. **Several banks interviewed for this study (especially in Eastern Europe) commented on the inadequacy or unavailability of accurate and up-to-date information sources to effectively validate relatedness or verify affiliations with the bank.** Unlike competent authorities, banks do not have access to government databases with information on individuals (e.g. national registry) and have to rely on their internal systems and on commercial databases. Prudential supervisors, as competent authorities, should in theory have access to government databases containing information on beneficial ownership of legal entities, however, in some countries such data does not exist, is unreliable or outdated, or there are practical barriers to access information in state corporate registries and beneficial ownership registries. Further, insufficient attention is paid by supervisory authorities to rigorous enforcement of transparency rules for legal entities, as this issue is still largely – but incorrectly – seen as an anti-money laundering issue when in fact, it has significant impacts on financial stability and the overall health of the financial sector.

Prohibition of RPTs

61. **Some countries have adopted a more conservative stance vis-à-vis RPTs.** According to the Basel Standards, transactions with RPs should not be undertaken on more favorable terms than transactions with non-RPs. In certain visited countries though, authorities and banks have adopted a more conservative stance, for example by precluding lending to members of the governing bodies[66] (or subjecting them to prior vetting from the supervisor– Ireland and Spain). In Ireland, loans to a RP exceeding EUR 1 million require the prior approval of the Central Bank.[67] In Spain, as a general principle, the provision of credit to board members and general directors and persons holding similar positions in the credit

65 This is the case in the EU for example, see Directive (EU) 2019/978 of EU Parliament and Council of 20 May 2019 (CRD V) which amends Art. 88 of the CRD IV and refers to the 10 percent threshold when identifying member of the management body business interest. See also the concept of "significant shareholder" in Ireland's Code of Practice on Lending to Related Parties (2022), as well as the notion of "participant" in the Banca d'Italia Circular 263 (December 2011) "Exposures towards related parties and conflict of "interests", Chapter 5.

66 The most prominent public bank in one visited country said it does not issue any form or type of loan, including the provision of guarantees, either directly or indirectly, to members of its management or supervisory bodies or to companies or other collective entities directly or indirectly controlled by them. Lending is presumed to be indirect when the beneficiary is a spouse or a person living in a de facto union, in a relationship with, or the like, up to the first degree, of any member of management or supervisory bodies of a company directly or indirectly controlled by any of the said persons.

67 See Irish Special Code of Practice on Lending to Related Parties. The original 2010 Code came into force on January 1, 2011, and was revised in 2013. The last version came into force on July 1, 2022: https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/credit-institutions/regulatory-requirements/gns-4-4-3-2-cp-on-rpl.pdf?sfvrsn=817d61d_8

institution is forbidden, unless otherwise approved[68] by the Bank of Spain.[69]

62. ***Ex-ante* supervisory approval of RPT might act as a deterrent against abuse; however, it could also have unintended consequences that supervisors should be mindful of and mitigate.** For example, it could generate a confusion of roles and responsibilities between banks and supervisors, tarnishing the reputation of the supervisor, should a bank default as a consequence of RPTs *ex-ante* approved by the supervisor. In countries with weak governance regimes, prior approval of RPTs can also increase corruption risks and other abusive practices (see **Box 1**).

Role of the board of directors

63. **The role assigned to the board varies from one country to another.** In Portugal, all transactions with RPs must be conducted at arm's length and approved by a minimum of two-thirds of the members of the management body, after the prior opinion of the supervisory body and of the risk management and compliance functions. In the UK, firms should (i) set a material threshold above which RPT receive prior approval from the firm's management body, (ii) ensure that firms record and monitor RPT using an independent credit review or audit process, and (iii) only permit exceptions which are reported to the senior management or management body.[70]

Box 1

The case of daisy chain

This case was found during a recent FSAP carried out in a low-middle-income country. The local regulation imposed several requirements for RPTs as follows: (i) limits to loans granted to directors; (ii) the Supervisor's prior approval of facilities to directors exceeding a certain amount; (iii) termination of office for directors failing to repay loans within two months after the written request by the bank. The assessment revealed a systematic abuse of RPs lending. To circumvent the supervisory prior approval and prudential limits requirements for RPs, directors started borrowing from banks other than the one in which they were directors. This phenomenon generated a so-called daisy chain – Director from bank A borrows from bank B, and Director from bank B borrows from bank A – and escaped supervisory oversight (at the time of the FSAP, loans to directors reached 20 percent of total loans at the system level). There were also signals of extensive forbearance practices. When facing financial difficulties, directors were indeed incentivized to borrow from other banks, directly or through family members, to regularize their position and avoid the termination of office prescribed by the regulation. This caused an evergreening of loans.

68 The capacity to approve the loans has been delegated by the Executive Commission of the Bank of Spain to the head of different supervision departments. The exercise of this capacity is reported quarterly to the Executive Commission.

69 Article 35 of Royal Decree 84/2015 lays down the conditions for such authorization, which is not needed for credit, loans, or guarantees which are granted pursuant to the terms set out in collective bargaining agreements applicable to all employees of the credit institution and standardized contracts, provided that the total amount granted to the same person, their second degree relatives or companies where those persons maintain a holding equal or higher to 15 percent or form part of their board, does not exceed the amount of EUR 200,000. For those contracts subject to authorization, the Bank of Spain will take into account, at least, the following criteria: a) The effects that the loan or guarantee may have on the sound management of the institution and its compliance with the applicable legislation; b) the effects that these transactions may have on the adequate allocation of responsibilities within the institution and the prevention of conflicts of interests; and c) the terms and conditions applicable to these transactions in view of the general interest of the institution, and, in particular, when compared with those granted to clients or to other employees different from board members and senior managers.

70 Prudential Regulation Authority Rulebook.

64. **Board prior approval of RPTs above a certain threshold or which pose a particular risk is a robust procedural guarantee consistent with the Basel standards.** Such approval ensures that the board is adequately involved and engaged in RPTs; however, it cannot be considered a panacea. The board is likely to have a more expert view of where the company interest lies when entering into RPTs. Yet, field work showed that the board might disguise rather than neutralize conflicts of interest, even when interested directors are excluded from voting. A dominant director does not necessarily need a vote to influence board decisions, and all directors might have an incentive not to enquire too closely into the terms of the transactions in exchange for similar treatment when they engage in self-dealing. Also, in some countries, banks' boards of directors may be represented and controlled by families/groups of connected people (members of a family (direct and related) and others such as former politicians loyal to the family/group).

Role of internal control

65. **While effective internal control mechanisms are an antidote against abusive RPTs, the banks' failures described in Chapter 1 show several deficiencies in risk management, compliance, and internal audit.** Breaches of prudential limits, deviations from the bank's decision-making process, and mismanagement of conflicts of interest were not always detected by the second and third lines of defense. Banks' policies and processes often did not set up the risk appetite towards RPs, e.g., the maximum amount of risk deemed acceptable in relation to own funds. Nor did they identify cases where the assumption of new risk towards RPs should have been assisted by adequate risk mitigation techniques (BCP #20, EC5). The risk management function did not oversee the internal limits assigned to business lines. The internal audit function did not verify the compliance with internal policies, promptly reporting any anomalies to Senior Management. The IT system did not comprehensively map RPs at each stage of the relationship, capturing all relevant internal and external information (banks' archives, credit register, market monitoring etc.).

Role of external auditors

66. **The role assigned to external auditors is controversial as it intersects with their responsibility to scrutinize frauds in financial statements.**[71] Internationally accepted auditing standards require the auditor to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of RPs and the effect of RPTs that are material to the financial statements. During the interviews, it was emphasized that, on the one hand, management is responsible for identifying all RPs; on the other hand, external auditors need to have a sufficient understanding of the entity and its environment to enable identification of the events, transactions, and practices that may result in a risk of material misstatement regarding RPs and transactions with such parties.

67. **In practice, auditors strive for an in-depth understanding of every RP financial relationship and transaction.** The BCBS expects external auditors to take into account the existence of significant RPTs when identifying and assessing risk of material misstatement and assessing controls in a bank.[72] In that regard, questions were raised as to whether external auditors are also responsible for detecting undisclosed RPTs in the course of their duties.

68. **As RPTs may involve sophisticated and carefully organized schemes, there is an unavoidable risk that some material misstatements of the financial statements may not be detected.** In the UK, for example, the audit profession has been under scrutiny over a string of scandals where auditors have been criticized for failing to spot financial problems at some well-known companies. A former auditor of one of these companies argued that it is not the role of accountants to uncover fraud. While none

71 See *ISA 550 on Related parties and ISA 240 on the Auditor's responsibility relating to frauds in an audit of financial statements.*

72 BCBS, External Audit of Banks, 2014, par. 162

of these cases were RPT related, there are other situations where significant RPTs[73] escaped external auditors' surveillance and one may wonder whether audit companies should do more to ascertain that, especially when it comes to banks, RPTs are not fraudulent.

69. **Audit firms also face difficulties in identifying groups of companies that are not formally related to each other but have economic inter-linkages.** The challenge in identifying inter-connectedness is also mostly related to the concept of beneficial ownership which does not fully cover the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted (see **Chapter 3**).

Outsourcing activities

70. **Fieldwork shows that outsourcing activities are not well captured in countries' RPT regulatory frameworks.** There are cases where banking legislation focuses only on lending to RPs, whereas misappropriation of a bank's value might be perpetrated by, for example, means of disproportionate advisory fees acknowledged to directors in exchange for consultancy services. Such transactions might escape supervisory oversight, because they might not be subject to notification or authorization requirements. Assessing the substantial fairness of these transactions is an important element for consideration by both supervisors and auditors.

NPLs and RPs

71. **The possible linkages between NPLs and RPs have been overlooked by supervisors in many countries.** This is clearly an area where potential abuse can materialize, including in the context of the COVID-19 pandemic during which payment holidays, debt moratoria, and loans restructuring were granted to support households and corporates. The close relationship between a bank and its RP can give rise to privileged treatment when the RP does not comply with the terms of the agreement. A defaulting RP may be granted moratoria or even partial or total forgiveness of the debt that would be otherwise denied to a non-related client. Discussions suggested that supervisors do not always pay close attention to the percentage of RPTs in NPLs or the percentage of forborne/rolled over loans with RPs. This should be a matter of close attention; especially as in some countries, a significant share of NPLs is caused by directed lending and RP lending.

73 E.g. the Anglo-Irish Bank in Ireland.

CHAPTER 3

RECOMMENDATIONS FOR DEALING WITH TRANSACTIONS WITH RELATED PARTIES

As discussed in the previous chapters, the risks associated with RPs are not always being looked at sufficiently rigorously or consistently in either developed or emerging countries. While there are clear international standards dealing with RPTs, there is widespread poor practice in that domain and, unlike corporate governance or risk management, there is no separate set of supervisory guidance on this topic released by the regulatory community. This chapter discusses what else should be done to guard against abuses in transacting with RPs going forward. It provides a set of actionable recommendations for different audiences, some backed by country examples.

72. **The issue of RPTs is not receiving the attention it deserves.** It became overshadowed by the post-global financial crisis regulatory agenda, focused on capital and liquidity, and then by the COVID-19 pandemic. Crises connected to undisclosed RPTs that have affected financial stability or/and put a high burden on taxpayers clearly indicate an urgent need for a fundamental change in the approach toward RPTs. Interviews conducted during this study showed that some countries have responded to the crises by engaging in significant transformations of their legal frameworks, introducing tools, cooperation models, and supervisory processes to protect their economies from suffering similar consequences in the future. These initiatives are welcome, but there is more to be done at several levels, as discussed below.

73. **The following sections provide a set of recommendations directed towards action by national legislatures and executive authorities; national supervisors; banks; and standard setters.**

Section 1. Recommendations for National Legislatures and Executive Authorities

74. **Grant supervisors independence and legal protection (in legal framework and practice).**

- Jurisdictions should grant banking supervisors the necessary independence and legal protection to carry out their functions without fear of reprisal, in line with international standards. Supervisory independence is one of the main gaps in BCP compliance, in advanced economies as well as emerging markets and developing economies. Inadequate independence and legal protection for bank supervisors could be contributing to a lack of supervisory actions to address RPT problems. The absence of legal protection for supervisory staff and agents may also be a factor, leading those regulators to look the other way. Recent research suggests that regulatory and supervisory independence is associated with a significant improvement in financial stability. Financial autonomy of the banking supervisor is also important to ensure the resources needed to implement the measures recommended in this paper.

75. **Broaden the legal definitions of RP and their RPTs and allow case-by-case determinations.**

- Narrow definitions of RPs and RPTs is a common problem and present a clear obstacle for banks and supervisors in determining whether a transaction is with a RP. Authorities should revisit their definitions of RPs and RPTs and determine if there is merit to expand its scope.
- The legal system should include a clear definition of "close family members" and criteria to identify them. In a business environment characterized by concentrated family ownership, the definition of RPs should be broadened to include complex inter-generational relationships (cousins, in-laws, aunts, uncles, grandparents, etc.) who may be able to obtain funds through corporate insiders.
- The definitions on RPTs provided by the BCBS in BCP #20 should be the minimum for any regulatory framework. In the euro area, for example, having common, harmonized definitions would represent a solid base for supervisors to do their job in identifying and monitoring transactions with RPs. Of course, countries may wish to go beyond the minimum and broaden their legal definitions.
- Countries should grant supervisors legal authority to exercise discretion on a case-by-case basis to determine the presence of RPs and RPTs, including through complex familial and business relationships, through family member associates who qualify as PEPs, or through the use of legal entities with hidden beneficial owners.
- To determine whether a transaction is with a RP, supervisors should be authorized to access information about non-financial companies. This authority is particularly important for transactions involving mixed conglomerates (i.e. between banks and non-financial entities in the same group) or shell entities with hidden beneficial owners. The law should empower supervisors to require banks to request information from the non-financial companies with which they do business and pass it to the supervisor for analysis.

76. **Establish a clear and uniform definition of beneficial ownership enshrined in the law or regulations, in line with international standards.**

- A lack of clarity regarding the definition and identification of beneficial owners makes determining RPTs extremely difficult, since transactions may involve legal entities whose ultimate owners are hidden. According to a recent IMF report,[74] most countries have systems for obtaining information on the legal ownership of an entity (that is, the persons or legal entities who are the legal titleholder), but the legal owner of record does not necessarily ultimately own or control the entity. In the course of customer due diligence and identifying RPs, there is a need to go one step further to identify its beneficial owners (that is, the physical person who owns or controls the legal entity). In addition to practical challenges in the identification of beneficial owners of legal entities, many countries have inadequate systems or no system at all for maintaining information on the beneficial owners of legal entities formed or doing business within their borders.[75]

- To enable banking supervisors to determine whether a transaction involves RPs, countries are encouraged to have a clear definition of beneficial owner enshrined in law and consistent with international standards (especially with the Financial Action Task Force Recommendations).

77. **Improve quality of information in corporate and beneficial ownership registries and ensure efficient access for bank regulators, supervisors, and financial institutions.**

- Regulators, supervisors, audit firms, as well as banks themselves, rely on access to high quality, reliable information on ownership of legal entities and arrangements – whether they are registered domestically or abroad – to conduct fit and proper tests of bank shareholders, monitor large exposures, and detect undeclared RPs. Mechanisms to disguise the identity of the true owners or controllers of legal entities enabled many examples of bank failures or large-scale bank fraud arising from excessive RPTs that were analyzed for this report. This is why it is essential to improve the quality of information in corporate registries and beneficial ownership registries through verification checks. It is equally important to apply deterrent sanctions and penalties for failure to report information to beneficial ownership registries or for reporting incorrect information.
- Authorities should set up a system to obtain and store current, adequate, and accurate beneficial owner information for legal entities formed or doing business within their borders and to ensure efficient access to that information to financial system regulators. Supervisors as competent authorities should also have access to beneficial ownership information and should utilize this information as part of fit and proper assessments. In line with FATF Standards on beneficial ownership, revised in March 2022, beneficial ownership information of legal entities should be held by a public authority or body (such as a tax authority, financial intelligence unit, company registry, or beneficial ownership registry), or countries need to develop an alternative mechanism of how authorities can efficiently access reliable beneficial ownership information.

78. **Place the burden of proof on those challenging RPT determinations.**

- One of the great challenges faced by supervisors is when a RPT determination is challenged in court by the parties involved or bank management. To discourage meritless challenges, safeguard court resources, and help ensure effective bank supervision, some countries have granted supervisors so-called presumption powers that, after the supervisor establishes certain facts, invert the burden of proof and put the onus on the bank to demonstrate that the transactions in question do not involve RPs.[76] Reallocating the burden of proof is a powerful tool that enables supervisors to deal with sophisticated cases involving complex ownership structures, especially in jurisdictions where transparency in corporate ownership is a concern.

74 Unmasking Control: A Guide to Beneficial Ownership Transparency, IMF, 7 October, 2022 at: https://www.imf.org/en/Publications/Books/Issues/2022/10/06/Unmasking-Control-A-Guide-to-Beneficial-Ownership-Transparency-517096

75 The Stolen Asset Recovery Initiative (StAR) provides technical assistance to countries in the process of reforming their legal and regulatory system for beneficial ownership disclosure and also assists with the implementation of reforms.

76 In the UK, the Prudential Regulation Authority (PRA) has the power to require, on a case-by-case basis, a firm to evidence whether an entity is a RP (PRA Rulebook's section on RPT risk). This is a discretionary power of the PRA based on a judgment-based approach. If the PRA is dissatisfied with a firm's position it may take actions including imposing requirements under section 55M of the Financial Services and Markets Act 2000.

- The legal framework must provide supervisory authorities with discretion to determine the presence of a RP transaction on a case-by-case basis, in line with BCP requirements. Inverting the burden of proof after such a discretionary determination would make it more difficult to overturn the supervisory authorities' decisions in court.

79. **Apply deterrent penalties to banks, senior managers, members of boards, shareholders, and other relevant individuals.**

- Weaknesses in enforcement powers, including low monetary penalties, may lead market players to treat penalties as a "cost of doing business" which in turn increases moral hazard. As a result, supervisors should have available an appropriate range of penalties to impose upon banks that attempt to circumvent RPT limits or bypass regulatory oversight.
- As contemplated in BCP #11 on corrective actions and sanctioning powers, possible measures to address questionable RPTs should encompass a wide range of civil penalties and provide sufficient deterrence commensurate to the seriousness of the problem. Penalties may include civil fines, replacement of senior management, suspension or debarment of individuals from the banking industry, disgorgement of profits or bonuses, limits on bank activities or participation in mergers, and other civil penalties.[77] Fieldwork has shown, however, that the sanctioning arsenal available to most supervisors often has serious limitations. Countries should ascertain that supervisors are empowered to apply sanctions to all parties involved in the violations, including board members, senior managers, shareholders, other relevant individuals, and the bank as a whole.
- Fieldwork indicates that civil penalties or fines applied to individuals involved in RPTs often prove a strong deterrent. The impact of those monetary penalties can be further enhanced by laws or regulations that prohibit banks from reimbursing or otherwise compensating a fined person, thereby lessening the impact of the fine.
- The sanctions regime should include the authority to penalize bank shareholders, especially in cases where shareholders failed to provide information to the supervisor on relevant business activities, relationships, affiliates, or the beneficial owners of a relevant legal entity.
- Penalties should include severe sanctions that, in the most serious violations, may be applied by other national authorities with investigative and prosecutorial responsibilities. The law should also permit some portion of monetary fines, in appropriate circumstances, to be paid to foreign authorities.
- Lastly, competent authorities should have a prudent supervisory culture and effective supervisory tools and processes to be able to effectively apply the available corrective powers that a supervisor has. While it is important to ensure that supervisors have the necessary powers to apply sanctions and corrective measures, it is equally important for them to have the willingness and the supervisory tools and processes to ensure that these powers could be applied on a timely basis to ensure problems, including those related to RPTs, are addressed early enough. Recent banking failures have demonstrated once again the importance of supervisors taking early and effective action to address banking weaknesses, including those related to governance and risk management.

77 A recent example of sanction applied to an individual can be found in the US. In 2022, the Securities and Exchange Commission (SEC) charged Eagle Bancorp, Inc., based in Bethesda, Maryland, and its former Chief Executive Officer and Chairman of the Board, with negligently making false and misleading statements about RP loans extended by the bank to the CEO's family trusts. Eagle and the CEO agreed to settle the SEC's charges. The SEC's order against Eagle finds that, from March 2015 through April 2018, Eagle failed to include loans to the CEO's family trusts totaling at times nearly USD 90 million in the RP loan balances included in its annual reports and proxy statements. Both SEC regulations and Generally Accepted Accounting Principles (GAAP) required Eagle to disclose these material RPTs. The SEC's complaint against the CEO charged him with violating the negligence-based antifraud and proxy provisions and making false certifications. Without admitting or denying the SEC's allegations, the CEO agreed to a permanent injunction, a two-year officer and director bar, and to pay disgorgement of USD 109,000, prejudgment interest of USD 22,216, and a penalty of USD 300,000. The settlement is subject to court approval; see https://www.sec.gov/news/press-release/2022-146

80. **Improve consolidated supervision to capture RPTs at group or conglomerate level.**

- An absence of, or gaps in, consolidated supervision are a key enabler for uncontrolled RPTs as banks can very easily lend to de facto affiliated entities that may even be based in other jurisdictions. The concept of consolidated supervision needs to be clearly defined in law, and the law needs to empower the supervisors to exercise consolidated supervision. Supervisors should also be empowered to access all information on the activities and business of a financial group or conglomerate (e.g., information on nonbank activities, international, and offshore activities and businesses). Along the same lines, supervisory bodies should be equipped with adequate resources in terms of human, material, and technological support to comprehensively identify all parties related to financial conglomerates.

Section 2. Recommendations for National Supervisors

81. **Set up prudential limits for exposures to RPs, deduct such exposures from capital when assessing capital adequacy, or require collateralization of such exposures.**

- BCP #20 states that "laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to RPs, to deduct such exposures from capital when assessing capital adequacy, or to require collateralization of such exposures." Prudential limits, deduction from capital, or mandatory collateralization can be considered the first line of defense against RPT abuse and as a result, countries should have these requirements in place either in the law or relevant regulations. In addition, as discussed earlier, there are several standards that have been overlooked or only partially implemented, that countries should consider, especially with regard to the RPT approval process. As set forth in BCP #20, EC #3, transactions with RPs and the write-off of RP exposures exceeding specified amounts or otherwise posing special risks should be subject to prior approval by the bank's board. Any persons benefiting from the transactions should not be part of the process of granting and managing the transaction (BCP #20, EC #40). These prudential standards and prohibitions are fundamental elements of an effective supervisory program to limit RP risks.

82. **Require banks to publicly disclose their shareholders above certain thresholds.**

- In line with the G20/Organization for Economic Co-operation and Development (OECD) Principles of Corporate Governance, countries are encouraged to require banks to publicly disclose their major shareholders including beneficial owners, and to cooperate with competent authorities in determining the suitability of their beneficial owners, including by making relevant information available to the competent authorities in a timely manner.

83. **Foster the role of internal controls, external audits, and risk management functions, on RPTs.**

- National supervisors should strengthen the role that internal controls (risk management, compliance, and audit departments) should play to prevent abusive transactions with RPs.
- The risk management function should measure the risks inherent to RPT; oversee internal limits assigned to business lines and control the consistency of the operations of each business line with the risk appetite defined by the internal policies. The compliance function must verify the reliability of the procedures and systems adopted to ensure compliance with internal and external regulations. The internal audit function should verify compliance with internal policies, promptly report any anomalies to senior management, and periodically report to the board on the bank's overall exposure towards RP and on other conflicts of interest. If necessary, internal audit can suggest reviews of internal policies and of the organizational and control structures deemed suitable to strengthen the oversight of these risks.

- The same holds true for external auditors. Audit of RPTs is not just as a disclosure issue (IAS 24), but an area where material misstatement of financial statements could occur as a result of fraud or error. Therefore, auditors should properly plan and perform RPT auditing, taking into account a bank's previous history of RPTs, the involvement in the business of family members, transactions on abnormal terms or unclear business rationale, the entity's ownership, and the governance structures. External auditors[78] should pay attention to: (i) RPs not identified and/or disclosed by management (for example, they should obtain a list of RPs from clients and/or compile a list based on their knowledge of the business and discussions with banks); (ii) assertions that RPTs are at arm's length (e.g. they should assess whether management assertions about RPTs are appropriate and obtain sufficient evidence to support such assertions); (iii) material RPTs outside the normal course of business and diligence exercised by internal controllers over RPTs. Auditors should perform modified, extended, or additional audit procedures, appropriate to the circumstances, whenever the risk of material misstatement increases beyond that which would ordinarily be expected or when material misstatement regarding RPs has occurred.
- Moreover, since supervisors can determine the scope of audit (BCP #27, EC #5), external auditors could be asked to exercise more intrusiveness in RPTs, with particular attention to the identification of the transactions and their disclosure. To strengthen external auditor reviews, supervisors should emphasize the importance of maintaining professional skepticism and due professional care. In addition, supervisors may want to underline to external auditors the importance of thorough audit review of banks' management of RP risk, which could even lead –in serious cases as contemplated in the legal framework– to suspension or debarment from providing auditing services to banks operating within the country.

84. **Strengthen the licensing process to facilitate scrutiny of RPTs.**

- Licensing is a fundamental process as it prevents institutions that would not be safe and sound, or that could pose a threat to the stability of the financial system, from entering the banking market in the first place. When granting a license, the supervisor acts as a gatekeeper. Its task is to ascertain that applicants are robust and comply with national requirements. In that regard, fieldwork reveals persistent gaps in countries' ability to access all the necessary information on the corporate structure of the entity to be licensed.
- The legal system should make clear that competent authorities may access all relevant information when assessing license applications, including obtaining complete and up-to-date information on a bank's major shareholders, including the ultimate beneficial owners. The review of applicants must provide sufficient information on the identity of these individuals, including any PEPs, as well as their fitness and propriety. Validating the true identities of these natural persons is crucial as it will allow supervisors to have the full picture of the corporate structure as well as a greater ability to identify transactions between the bank and its major shareholders, including ultimate beneficial owners. The licensing authority should not approve any application where the corporate structure and ownership of the bank is unclear or not fully disclosed.
- Ensuring at the licensing stage that the bank has a transparent ownership structure and that the bank's beneficial owners are suitable will facilitate the scrutiny of RPTs once the bank starts its operation.

85. **Periodically reassess transparency and the fit and proper conditions of a bank's owners.**

- The process to identify significant shareholders, including ultimate beneficial owners of a bank is at the core of the RP system as well as essential

78 Auditors should follow the International Standard on Auditing 550 Related Parties, which alerts on possible material misstatements associated with RP relationships and transactions, in accordance with the reporting framework in force. It warns that "*(e)ven if the applicable (..) framework establishes minimal or no RP requirements, the auditor nevertheless needs to obtain an understanding of the entity's RP relationships and transactions sufficient to be able to recognize fraud risk factors and to conclude that the financial statements are fair and not misleading*".

to oversight of the bank as a whole, and it is not a one-off exercise. A bank's ownership structure is subject to change and requires ongoing monitoring. The biggest risk is that after an initial successful fit and proper assessment of the owners of a particular financial institution, control is transferred to other persons whose identity is not disclosed to the supervisors.

- To mitigate this risk, supervisors should conduct periodic bank-wide reviews or individual reassessments of shareholders and beneficial owners to ensure they continue to comply with fit and proper requirements, and that there are no undisclosed beneficial owners. This power should be embedded in a country's primary legislation to ensure that any supervisory decisions have an appropriate legal basis. Inclusion of ownership questions in periodic reassessments will also facilitate data collection. A statutory basis and formal periodic assessment of bank ownership will give supervisors adequate authority and opportunity to request information from different sources and to apply sanctions when requested information is not forthcoming.
- Moreover, internal procedures and guidelines will need to be developed to ensure the high quality of the reassessment process and effective case management. These internal processes can be embedded in the SupTech tools[79] that will support documentation, workflow of the process, and automation of repetitive processes.[80]
- To reduce the burden on supervisory resources imposed by periodic ownership reassessments, bank supervisors may wish to consider two options. In accordance with the BCPs, proposed changes in ownership (including beneficial ownership) over a particular threshold should be subject to supervisory approval or notification, which could be used as a trigger for reassessment of shareholder and beneficial owner transparency in those cases. Periodic reassessment might also be performed for banks that engage in higher risk activities or impose systemic risks on the country's financial system and which may have a less transparent ownership structure.

86. **Reinforce RPT scrutiny during on-site examinations.**

- Many jurisdictions pay little or no attention to RP risks during routine bank examinations. During on-site visits, supervisors tend to ask about RPT risks as part of a larger credit risk analysis and often limit RPT inquiries to two questions: whether the bank has policies in place and whether transactions are at arm's length. Targeted RPT reviews are rare. Supervisors should be looking more deeply into these issues.
- Supervisors should have in place specific processes to review RPTs. On-site inspection teams should ask the bank to provide a complete list of RPs and all transactions and credit arrangements between them and the bank during the relevant inspection period. Inspectors should pay careful attention to the cash flows between RPs, something that is often missing. Inspectors should also review all characteristics of loans granted to RPs (e.g. period of grace granted, roll-overs, and any write-offs) and perform a detailed review of a sample of RP loans.[81] In that regard, inspectors should assess credit underwriting compliance with the bank´s internal credit policies and prudential regulations and examine conditions for disbursements (e.g. source for repayment, cash, and transfers). Checking the soundness and prudence of these processes and their alignment with applicable regulations and with international practices and standards is also warranted. Inspectors should also compare RP exposures to a bank's capital, especially with respect to concentration risks and large exposure limits.
- Supervisors should be attentive to any signs or red flags (see **Annex 1** for an indicative list) that may suggest the presence of undisclosed RPTs (e.g. loans granted not at arm's length or under otherwise unusual conditions). Another route worth considering would be to perform targeted

79 SupTech is the application of emerging technology to improve how supervisory agencies conduct supervision.

80 A dedicated software for ensuring shareholders transparency and identification of RPTs was implemented in Moldova in 2023 (https://www.bnm.md/en/content/premiere-region-moldova-will-implement-usaid-support-state-art-it-solution-prevent-money).

81 Inspector's attention should also cover other types of RPTs, besides loans.

on-site reviews focusing on banks' governance and risk culture to help address underlying issues behind RPT problems.

- Other practices that the supervisor should pay attention to are cross-banking loans to managers (also called daisy chains). In these schemes, directors borrow from banks other than the one they are employed by, so as not to be classified as RPs, circumventing prudential limits and escaping supervisory scrutiny (e.g. in countries where RPTs have to be pre-approved by a government authority). In one country visited by the mission, this phenomenon had reached significant proportions possibly causing evergreening of loans (see **Box 1** on page 30).
- More broadly, the supervisor should consider conducting special, horizontal reviews across the entire banking sector to determine whether RP exposures and interconnectedness between relevant actors are well captured by bank risk management systems, whether connected lending is being scrutinized, and whether the country's data systems are accurately tracking key indicators (see **Box 2**).

Box 2

Ukraine

The National Bank of Ukraine changed bank ownership disclosure rules and forced all nationally licensed banks to reveal their ultimate beneficial owners. In parallel, and with the assistance of audit companies, it carried out a comprehensive study to address problems arising from concealed and underreported RP exposures. Around 100 banks were analyzed by the National Bank and multiple problems were identified. 44 banks were instructed to submit individual plans to correct breaches of requirements and to reduce outstanding loans to RPs. The individual plans contained several corrective measures including repayment of loans by RPs, reducing numbers of RPTs (wind-down plan), foreclosing collateral on balance-sheet, recognizing the loan as non-performing, taking cash as collateral, making provisions for NPLs of RPs, and increasing capital.

Portugal

In 2018, the Central Bank of Portugal launched a thematic review covering conflicts of interest and RPT policies. The objective was to confirm if they complied with the applicable legislation and guidelines. The review covered two significant institutions (supervised by the SSM) and five less significant institutions overseen by the Bank of Portugal. Conducted mainly off-site by a dedicated team, the analysis revealed some shortcomings.[82] In the wake of this supervisory work, the Bank of Portugal organized a workshop with selected credit institutions to share supervisory expectations and also to present the main conclusions of the thematic review. The credit institutions were asked to review their policies to incorporate Bank of Portugal recommendations. In addition, findings concerning the two systemic institutions were shared with the ECB which issued recommendations to the institutions concerned. Banks not included in the sample were asked to do their own self-assessment and the outcomes of these were analyzed by the Bank of Portugal and used to request policy adjustments from the banks. The conclusions of the thematic review were considered in the drafting of Notice no.3/2020, published in July 2020, on internal governance and internal control, and supported the currently in force regulatory RPT regime mentioned above.

82 Including (i) inadequate definition of RPs; (ii) no specific reference to the fact that these transactions should be conducted at arms' length; (iii) RPTs not captured by risk management and compliance functions; (iv) not expressly stated that the supervisory body gives its opinion to the most relevant transactions (at least) with RPs and that it takes notice of the other ones; (v) policies do not foresee the possibility of approval by shareholders of the most relevant transaction with RPs, at the management body request.

87. **Address RPT problems specific to state-owned banks (SOBs).**

- SOBs can be victims of toxic RPTs and supervisors are encouraged to look into this issue more deeply, especially for deposit-taking SOBs. There are still many commercial SOBs across the world which are being forced by the "state shareholder" to finance inefficient state-owned enterprises or other government entities (such as local governments). Therefore, governance risks involved in RPTs are equally relevant for SOBs, arguably even more so because of the risk of undue political interference. The BCPs do not include specific details on how to deal with RPTs in SOBs. However, in principle, SOBs should be supervised under the same rules as private banks that carry out similar activities, and specific governance requirements of a RP framework (e.g., the arm's-length rule, board approval requirement, and reporting duties) should apply to dealings with SOBs. They should also be required to operate to the same high level of professional skill and discipline as required of privately-owned commercial banks in order to preserve a strong credit and control culture in the banking system as a whole. Further, supervisors should carefully monitor exposures of SOBs to RPs 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. Enhancing the governance of SOBs could also ensure that the risks associated with RPTs are mitigated.

88. **Seek independent third-party opinions.**

- Similar to other types of risks, supervisors may choose to outsource the assessment of specific RPT problems to an independent reputable firm or to conduct an industry-wide review of RPTs, provided there is a clear and detailed mandate for the work.
- Assistance may be considered when RPT problems are widespread or systemic in the financial sector, and the supervisors do not have the capacity and skills to perform a comprehensive assessment of RPT problems in a timely manner to ensure these issues are quickly addressed. The benefits include getting an independent opinion on specific aspects of the RPT problem.

89. **Provide guidance on what constitutes transactions outside market conditions.**

- As stipulated in BCP #20, transactions with RPs should not be undertaken on more favorable terms than corresponding transactions with non-related counterparties (with the exception of terms being part of the overall remuneration package [e.g. staff receiving credit at favorable rates]). In practice though, field work has shown that little attention is being paid by senior bank management and internal control units to the conditions applied to RPTs. Supervisors may wish to communicate more clearly on these important aspects and publish examples indicating possible terms outside market conditions. Below is an indicative list of such signs (**Box 3**). Of course, transactions outside market conditions should be subject to sanctioning and corrective measures.

90. **Increase banks' disclosures on RPTs.**

- Supervisors should require banks to increase transparency and accuracy of RPT disclosures. International standards (e.g. BCP #28, EC #2; IAS 24; BCBS Corporate Governance Principles for Banks [Principle 12], and OECD Principles on Corporate Governance) require periodic public disclosures of information to enable users of financial statements to evaluate the nature and financial effects of RP relationships and transactions. Disclosure should include both qualitative and quantitative information on material RPTs and aggregate exposures to RP. In practice though, the scope and content of RP information and the level of disaggregation and details are uneven or insufficient.
- More should be done to ensure that RP information disclosed on bank financial statements is accurate, complete, and meaningful. To improve financial statement transparency, the supervisor could issue further guidance to the banking industry on expected RP disclosures, followed by an initiative using reviews, deficiency reports, and sanctions (including civil fines) to encourage individual financial institutions to strengthen their RP disclosures.

91. **Get prepared to resolve systemic RPTs within a jurisdiction.**

Box 3

Indicative list of transactions deemed to be outside market conditions

- accepting less security for the performance of obligations than is required from other clients;
- acquiring property of low quality or at an inflated price from a person related to the bank;
- making an investment in securities of a person related to the bank that the bank would not have made with non-related counterparties;
- paying for goods and services provided by a person related to the bank at prices higher than usual;
- selling a property related to the bank to a person at a value lower than the bank would have received from the sale of such property to non-related counterparties;
- approving transactions through a procedure different from the procedure specified by the bank for similar counterparties;
- approving loans or granting guarantees exceeding the internal limit without any sensible economic ground;
- approving a transaction through a less stringent procedure that the procedure specified by the bank for similar counterparties;
- accepting collateral without proper appraisal or accepting less collateral than the bank would have required from an unrelated person;
- issuing additional credit despite existing loans in arrears or creating a concentration of risk that the bank would not have approved for an unrelated person.

Source: WB field work

- Dealing with RP exposures of systemic proportions is a complex undertaking, and supervisors should use caution. The resolution of RPTs must consider the size and nature of the transactions, each bank's initial capital position, and broader financial stability considerations.[83] While the supervisor will want to instruct the bank to unwind excessive RPTs (i.e., comply with the RP framework) as quickly as possible, this may take a few years when RP exposures have become a system-wide concern. In that case, the supervisor needs to prepare a timebound plan for the design and implementation of necessary actions to unwind excessive RPTs. Banks should provide a detailed strategy to bring their RP exposures below regulatory limits and, as needed, align their terms with prudential requirements (e.g., by phasing out preferential terms, in compliance with contractual provisions on modifications). Periodic unwinding targets should be expressed in absolute and relative terms, such as in overall volume and as a share of regulatory capital. Only credible unwinding plans should be accepted, as determined by the supervisor. Service contracts with, or outsourcing to, RPs should be made compliant with arm's-length requirements, or otherwise be phased out.[84]

92. **Foster domestic and international cooperation and information exchange among supervisory authorities.**

- A significant part of the information necessary to analyze RPTs is not collected by the supervisor. Key data can be captured by different national

83 "Resolving Opaque Bank Ownership and Related-Party Exposures—A Possible Approach", IMF, Monetary and Capital Markets Department and Legal Department, (forthcoming).

84 ibid.

authorities such as financial intelligence units, securities authorities, tax authorities, authorities responsible for legal entities registration, collateral registries, and others. In the case of non-resident shareholders and debtors, the most relevant information is collected by foreign authorities.

- Enhancing domestic and international cooperation between supervisors, through bilateral or collective agreements, will assist supervisors in obtaining the necessary information, including beneficial ownership information, to identify undisclosed RPs and RPTs. It is recommended that agreements over the exchange of information include exchange of beneficial ownership information, with access for supervisors.
- Jurisdictions with a large "offshore" company incorporation business sector that primarily serves non-resident clients require an efficient process of exchanging information on beneficial owners with foreign authorities. Since responding to a multitude of individual requests for information from foreign authorities can be time and resource intensive and cause delays, it can be useful if registries in jurisdictions with significant "offshore" incorporation volumes for non-resident clients publish some (limited) information on legal entities and their beneficial owners publicly online. This allows competent authorities to quickly conduct preliminary checks online – if during an investigation or vetting for the fit and proper test further information is required, a request can be sent to the foreign jurisdiction.

Section 3. Recommendations for Banks

93. Strengthen board approval and oversight.

- According to BCP (CP #20), transactions with RPs and the write-off of RP exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank's board. In the same vein, according to the BCBS Guideline on Corporate Governance Principles for Banks, the board should ensure that transactions with RPs (including internal group transactions) are reviewed to assess risk, are subject to appropriate restrictions (e.g., by requiring that such transactions be conducted at arm's length), and ensure that bank resources are not misappropriated or misapplied. In practice though, as discussed in Chapter 2, these sound principles are not always applied.
- Banks should be encouraged to strengthen board approval and regular oversight of RPTs, including by submitting to the board regular reports of specific RPTs and overall RPT exposure, perhaps on a quarterly basis. Review of those reports could be undertaken by the board-level risk committee or audit committee. The board reports would also provide a useful record over time of RPTs. To get a strengthened board review process underway, the board could require reports on RPTs through an independent credit review or audit process (as per CP #20). Further, all exceptions to RP policies, processes, and limits should be reported to the board for timely action, including giving the board an opportunity to disapprove specific transactions that violate normal practice.
- Enhancing the role of independent directors (board members) in the RP review and approval process is also recommended, since independent directors are more likely to provide an objective view if the interests of bank management, auditors, shareholders, or beneficial owners diverge. Independent directors could serve on the board committee or subcommittee vetting RPTs and help provide checks and balances on the board when overseeing RP issues.

94. Proactively use beneficial ownership information for vetting shareholders, clients, and identifying RP and their RPTs.

- Banks do not have access to beneficial ownership registries in all countries. Some countries restrict access to such information to competent authorities only. In other countries (e.g. Austria), registries containing beneficial ownership information offer layered access modes, with more limited access for regulated banks and other financial institutions, compared to law enforcement access.

- Banks also hold valuable information on beneficial owners of financial accounts held by legal entities. Through discrepancy reporting mechanisms, this information can be used to complement or corroborate information on beneficial ownership of legal entities held by public authorities and may help improve accuracy of registry information – if banks have access to such information.
- Therefore, it is recommended that in countries where beneficial ownership information collected by public authorities is not publicly accessible, and banks do not have access to such registries, they should demand access rights and proactively use beneficial ownership information for vetting shareholders, clients, and identifying RP and their RPTs.

95. **Develop robust whistleblower mechanisms.**

- The development of robust whistleblower mechanisms, including adequate legal protections for whistleblowers, at supervisory authorities and at financial institutions are an important factor in raising alarm bells of suspected RPT problems in a sector. For RPT schemes of a larger size and complexity, there are always insiders in the banking sector and in government agencies that are aware of fraudulent transactions with RPs and of cover-ups at the political level. They can ring alarm bells when internal control mechanisms are overruled by senior management. Having such mechanisms and legal protections for whistleblowers is especially important with regard to the fit & proper test and the process of approving bank shareholders by the supervisor.

Section 4. Considerations for Standard Setter Bodies

96. **Expand the definitions of RP and their RPTs and supervisory reporting requirements.**

- The definitions of RP and their RPTs as contemplated in BCP (CP #20) could be further expanded to also cover commitments to provide support, both to and from RPs, including funding. It is important to encompass intra-group operations in the definition of RPTs. The BCBS could also expand supervisory reporting requirements beyond the aggregate exposures. As set forth in BCP #20, EC #7, the supervisor obtains and reviews information on aggregate exposures to RPs. Practice has shown that in countries where there was abuse of RPTs, the lack of sufficient and frequent reporting was one of the sources of the problem preventing supervisors from acting at an early stage. More granular and periodic reporting is therefore warranted, for example by requiring banks to also report material transactions with RPs on an individual basis. This is already the case in several countries where banks are required to generate quarterly reporting consisting of nominative information exceeding a certain threshold, in addition to data on an aggregated basis.

97. **Issue supervisory guidance on RPTs.**

- The BCBS may wish to issue specific guidance on how to design and implement a regime for RPTs consistent with the internationally agreed principles. As discussed in this paper, the concept of RPTs is not being looked at rigorously or consistently by supervisors and banks alike. Despite the efforts made at the international level by the standard setting bodies, RPT problems remain a concern in many countries. While the BCPs governing RP and their RPTs are clear, there is no associated Basel document to spell out the risks and expectations. The 2015 BCBS Guidance on Corporate Governance Principles for Banks contains only a few references to RPTs. To assist countries' supervisory authorities and the industry in tackling this problem more decisively, the BCBS could consider elaborating a specific guidance on the application of the BCPs that relate to RP and their RPTs which could apply to both BCBS member and non-member jurisdictions, including those jurisdictions in which supervisors are facing acute RP problems.
- Another option worth considering would be for the BCBS or the Financial Stability Institute to issue a paper on good practices to identify and examine RPT issues and problems.
- Lastly, the BCBS may wish to consider to further elaborate RPT risks and issues in the Corporate Governance principles.

Section 5. Other initiatives worth considering

98. **Encourage the adoption of the legal entity identifier (LEI) to better trace relationships between parties.**

- The 2008 global financial crisis highlighted significant obstacles to identifying and tracing financial transactions across the international financial system. Problems in the financial sector since then suggest many of the same obstacles remain. The LEI is a 20-character, alpha-numeric code based on the International Organization for Standardization standard 17442. It connects to key reference information that enables clear and unique identification of legal entities participating in financial transactions and helps to identify those entities' parents and direct affiliates. LEI data can be accessed at no cost and can be regarded as creating a global directory of legal entities, greatly enhancing transparency in the global marketplace. The Financial Stability Board has stated that global LEI adoption underpins multiple financial stability objectives; it improves risk management in firms and provides a better assessment of micro and macro prudential risks; it promotes market integrity while containing market abuse and financial fraud; and it supports higher quality and accurate financial data overall. In 2022, the Financial Stability Board published a report exploring options to improve the adoption of the LEI,[85] in particular for use in cross-border payments.
- Supervisors may wish to consider requiring banks and their affiliates to obtain LEIs and to direct the legal entities with which they do business or for which they open accounts to do the same. The use of LEIs may enhance banks' management of information across legal entities and facilitate a more comprehensive assessment of risk exposures. In addition, the adoption of the LEI in the banking sector may have several benefits regarding RPTs, including providing supervisors with assistance in identifying bank subsidiaries, affiliates, and parties that the bank exerts control over or that exert control over the bank. That information will help supervisors reviewing transactions to better trace the entities involved and identify any RPs.

99. **Explore SupTech solutions to support continuous monitoring of bank ownership as well as identification and oversight of RPTs.**

- With the development of technology and analytical tools that can process big amounts of unstructured information, the different sources of information that can be used by supervisors increases significantly. These include information from court decisions, news, contracts, or even social media. So far, these tools have not been well used by all supervisors as they require significant resources. However, SupTech solutions are likely to increase the effectiveness of monitoring methods, including RP identification and oversight.

85 https://www.fsb.org/wp-content/uploads/P070722.pdf

ANNEX 1

KEY STANDARDS CONCERNING RPTs AND OTHER RELEVANT PRINCIPLES

The mandate of each standard setter determines the focus and contents of each standard. Thus, the purpose of the OECD corporate governance framework is to help build an environment of trust, transparency, and accountability necessary for fostering long-term investment; the objective of International Accounting Standards Board financial reporting standards are to provide useful financial information in making decisions relating to providing resources to the entity; the aim of the BCBS rules are to strengthen regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability; the goal of the FATF is to prevent money laundering and the financing of terrorism; and the International Organization of Securities Commissions aspires to protect investors, and ensure fair, efficient and transparent markets.

Standard: **BCBS** **BCPs (2012)**

Definition	The definition of RP **corresponds to the supervisor**. It should include, at a minimum, those firms (subsidiaries, affiliates and special purpose entities) that control the bank or are controlled by the bank; the bank's major shareholders, board members, senior management and key staff,[86] their direct and related interests, and their close family members as well as corresponding persons in affiliated companies. **Transactions** include on- 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 and incorporate situations in which an unrelated party subsequently becomes a RP.
Terms	At **arm's length**.
Governance	Banks to have policies and processes to **prevent persons benefiting** from the transaction and/or persons related to such a person from being part of the process of granting and managing the transaction. RPTs, including write-offs, to be **approved by the board** if large or otherwise especially risky. Board members with **conflicts of interest** excluded from the approval process.
Prudential	General or case by case **limits** for exposures to RPs, **deducted** from regulatory capital, or **collateralized**. Limits as strict as large exposure limits.
Risk management	Banks must have policies and processes to **identify** individual RPTs as well as total exposures, monitor and report through an independent credit review or audit process. **Exceptions** are reported to the appropriate level of the bank's senior management and, if necessary, to the Board, for timely action. Senior management **monitors** and boards **oversee** RPTs on an ongoing basis.

86 Key staff is not defined by the Basel Committee. Therefore, its definition corresponds to the supervisor.

Supervisory reporting	Supervisor has the power to **require information on aggregate**, solo and consolidated basis, on RPTs
Disclosure	**Qualitative and quantitative** information on aggregate exposures to RPs and transactions with RPs

Standard: BCBS Corporate Governance for Banks (2015)

Restrictions	Among their overall responsibilities, boards should ensure that transactions with RPs (including internal group transactions) are reviewed to assess risk and are subject to **appropriate restrictions** and that corporate or business resources of the bank are **not misappropriated or misapplied.**
Conflict of interest	Boards should have a formal written **conflict of interest policy** including the board members' duty to avoid conflicts of interest; examples of members' conflicts of interest; rigorous review and approval processes for members who perform certain activities; duty for members to promptly disclose any actual or potential conflict of interest; responsibility of members to abstain from voting on matters where conflicts of interest may exist; procedures for ensuring that RPT are made on an arm's length basis; way in which the board will deal with any non-compliance with the policy. Boards should have an objective compliance implementation process.
Disclosure and transparency	Banks should apply the disclosure and transparency section of the **OECD principles**. Disclosure should include **material information** on the bank's RPTs.

Standard: **OECD Principles of Corporate Governance (2023)**[87]

Rights and equitable treatment of shareholders

Shareholders have the right to **equitable treatment** and **key ownership functions** and obtain effective **redress** in case of violation. Which entails:

- Approval of RPTs ensuring **proper management of conflicts of interest** and protection of company's and shareholders' interest. An effective framework should include a broad and precise definition of RP –considering proportionality– approval procedures, monitoring and disclosure).
- **Disclosure to the board of material interest** by members of the board and key executives.
- Protect minority shareholders from **abusive actions** by controlling shareholders and prohibit abusive self-dealing (i.e. to the detriment of the company).

Disclosure and transparency

Timely and accurate disclosure is made on all material matters regarding the corporation, including ownership and governance of the company. Which entails disclosing:

- Major share ownership, including **beneficial ownership**, and voting rights. These should include group structure and intra-group relations, major shareholders that may significantly influence or control the company, shareholdings of directors, and RPTs.
- Fully disclose **RPTs and their terms — individually**. All RPs should be properly identified, including, at least, controlled (or being under the control of) entities; significant shareholders and their family members and relations; and key management personnel. (For instance, beneficiaries with ownership above 5% to report the transaction to the board and board, in turn, disclose to the market). Materiality should be defined, and material transactions with consolidated subsidiaries should be also disclosed.

Responsibility of the board

The board effectively **monitors** management and is accountable to the company and the shareholders. Which entails:

- Board members should act fully informed, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.
- Boards should **monitor and manage potential conflicts of interest** of management, board members and shareholders, guarding against abuse in RPTs. The instances to which these functions are assigned (internal audit, general counsel) should have direct access to the board.
- Boards should ensure that appropriate **control systems** are in place. **Independent board members** can play an important role in areas of diverging interests between management, the company, and shareholders. Boards could consider assigning tasks concerning areas with potential conflicts of interest, such as RPTs, to specific committees with a sufficient number of non-executive board members capable of exercising independent judgement.

87 A new version was released the 11th of September 2023. For the purpose of this paper, it does not significantly modify the 2015 version.

Standard: **OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOEs) (2015)[88]**

Disclosure and transparency	SOEs should report material financial and non-financial information in line with internationally recognized standards of corporate disclosure. This includes, among others, (7) financial assistance, including guarantees, received from the state and (8) **material transactions** with the state and other related entities.
Equitable treatment of non-controlling private shareholders	Recognition of the rights of shareholders and ensure equitable treatment and equal access to corporate information. Which entails: ◆ Prohibit insider trading and **abusive self-dealing,** ◆ Prevent pursuing objectives that are not in the interest of the bank and are thereby to the detriment of other shareholders, such as **inappropriate RPTs,** ◆ Facilitate the **participation of minority shareholders** in fundamental corporate decisions in situations where there may be a conflict of interest, such as the approval of RPTs, ◆ Carry out transactions between the state and SOEs, and between SOEs, on **market consistent terms,** to prevent abusive RPTs.

Standard: **International Accounting Standards Board IAS 24. RP Disclosures (2009)[89]**

Definition of RPs	It is enunciated in broad terms and refers to individuals and firms in their relation to the reporting entity. **Physical persons** are RPs when they control or jointly with other partners control (i.e., ability to affect his variable returns from the firm, or subsidiary), have significant influence (i.e., power to participate in financial and operating policy decisions, or associate), or are members of the key management personnel (i.e., persons who have responsibility for planning, directing, and controlling the activities of the firm, including board members). In addition, close members of the family (i.e., who may be expected to influence, or be influenced, in their dealings with the firm) are also considered RPs (i.e., children and spouse or domestic partner, children of the spouse or domestic partner, and dependents of both). **Firms** are related when they are part of the same group, are associates or joint ventures, are controlled or jointly controlled by the same individual (who is a RP), a RP individual has significant influence or is a key manager of the firm.

88 The Guidelines are recommendations to governments on how to ensure that SOEs operate efficiently, transparently and in an accountable manner. They are the international standard to exercise state ownership avoiding the pitfalls of both passive ownership and excessive state intervention. The Guidelines provide advice on how governments can ensure that SOEs are at least as accountable to the general public as a listed company should be to its shareholders. They are a complement to the OECD Principles.

89 The US Financial Accounting Standards Board have issued similar requirements, albeit with a few differences. These include, for instance, the disclosure of the ultimate parent, allowances for doubtful debts and amounts written off, commitments, which are non-mandatory in US GAAPs; disclosures concerning tax expenses and tax-related balances with affiliates, which are non-mandatory in IASs. See Standard 850 Related Party Disclosures.

Definition of RPTs

A RPT is defined as a transfer of resources, services, or obligations between a company and a RP, regardless of whether a price is charged.

Disclosures

Relationships and nature and terms of the RPTs should be disclosed.

In case of control, regardless of whether there have been transactions, the relationship should be disclosed, up to the ultimate controlling party.

RPTs during the periods covered by the financial statements should be disclosed, in the consolidated and individual statements, broken down by each category of RP (parent, entities with joint control or significant influence, subsidiaries, associates, joint ventures, key management personnel of the entity or its parent, and other RPs), including: (i) amount and outstanding balances of the transactions, including commitments, (ii) terms and conditions, including guarantees, (iii) provisions for doubtful debts and expense during the period.

Explicit disclosure on whether or not RPTs were made on arm's length basis can only be made if such terms can be substantiated.

Example of RPTs are: purchases or sales of goods, purchases or sales of assets, delivery of services, leases, transfers of research and development, transfers under license agreements, transfers under finance arrangements, contributions (including loans and equity contributions), provision of guarantees or collateral, commitments to do something including executory contracts, and settlement of liabilities on behalf of the RP.

Disclosures of government-related entities

Government-controlled entities are exempted from disclosing RPTs to the same extent. Disclosures are limited to (i) name of the controlling government and nature of the relationship, and (ii) nature and amount of individually significant RPTs (in terms of size, terms, carried outside normal business operations, reported to senior management, or disclosed to supervisory authorities) and quantitative or qualitative indication of collective RPTs.

Standard: **FATF**
FATF Recommendations (2021) / Guidelines on beneficial ownership of legal persons (2023) / Guidance for a risk-based approach. Banking sector (2023)

Reporting of beneficial ownership	Adequate, accurate and timely information on beneficial ownership and control of legal persons **available for competent authorities**. Consider measures to facilitate access to beneficial ownership and control information by financial institutions.
Governance	Clients' due diligence must include, when applicable, the identification of the ultimate beneficial owner, as well as understanding the purpose and nature of the business relationship. Risk-based approach. Enhanced due diligence for riskier clients, including checking more information and closer monitoring of the business relationship.

Standard: **International Organization of Securities Commissions Principles for periodic disclosure by listed entities (2010)**

Definition	RPs include, among others, the issuer's directors and senior management, any nominees for director, beneficial holders of a significant amount of the issuer's securities, and the immediate family members of all of these persons, as well as affiliates of the issuer.
Disclosures	**Material RPTs** should be disclosed to help investors get a complete picture of the issuer's financial relationships and identify potential conflicts of interest. Disclosure –including in interim periodic reports– refers to items such as the nature of the relationships, description of the transaction, business purpose and amount of transaction. It may also include the issuer's policies and procedures for the review, approval or ratification of transactions with RPs, such as whether a special committee is responsible for approving these transactions.

Standard: **United Nations Convention Against Corruption**[90]

Preventing corruption in the private sector	**Article 12.1** Countries should take measures to **prevent corruption involving the private sector, enhance accounting and auditing standards in the private sector** and, where appropriate, provide effective, proportionate and dissuasive civil, administrative or criminal penalties for failure to comply with such measures.
Codes of conduct and prevention of conflicts of interest	**Article 12.2** Measures to achieve these ends may include (...) (b) Promoting the **development of standards and procedures designed to safeguard the integrity of relevant private entities,** including codes of conduct for the correct, honourable and proper performance of the activities of business and all relevant professions and **the prevention of conflicts of interest,** and for the promotion of the use of good commercial practices among businesses and in the contractual relations of businesses with the State.
Transparency of corporate entities	**Article 12.2 (c)** Promoting transparency among private entities, including, where appropriate, **measures regarding the identity of legal and natural persons involved in the establishment and management of corporate entities.**
Internal auditing controls	**Article 12.2 (f)** Ensuring that private enterprises, taking into account their structure and size, **have sufficient internal auditing controls to assist in preventing and detecting acts of corruption** and that the accounts and required financial statements of such private enterprises are subject to appropriate auditing and certification procedures.
Regulatory and supervisory regime for banks & non-bank financial institutions	**Article 14.1** Countries should institute a **comprehensive domestic regulatory and supervisory regime for banks and non-bank financial institutions** (...) to deter and detect all forms of money-laundering, which **regime shall emphasize requirements for customer and, where appropriate, beneficial owner identification, record-keeping and the reporting of suspicious transactions.**

90 The United Nations Convention against Corruption was adopted by the UN General Assembly in October 2003 and entered into force in December 2005. The Convention covers many different forms of corruption, such as bribery, trading in influence, abuse of functions, and various acts of corruption in the private sector. It is the only legally binding international anti-corruption instrument and the vast majority of United Nations Member States are parties to the Convention (189 parties as of Nov 2021). Text of the Convention is available at the following link: https://www.unodc.org/unodc/en/corruption/tools_and_publications/UN-convention-against-corruption.html

Verification of customer identity by financial institutions

Article 52.1 Countries should **require financial institutions within its jurisdiction to verify the identity of customers, to take reasonable steps to determine the identity of beneficial owners of funds deposited into high-value accounts** and to conduct enhanced scrutiny of accounts sought or maintained by or on behalf of individuals who are, or have been, entrusted with prominent public functions and their family members and close associates.

ANNEX 2

RELATED PARTY CRITERIA USED BY THE NATIONAL BANK OF UKRAINE

Below is an excerpt of a Ukrainian regulation issued in accordance with the new article 52 of the Banking Law that empowers the National Bank of Ukraine to declare a party as a RP of a bank if certain criteria, as determined by the National Bank, are met. This regulation specifies these criteria in a structured form, with one group of criteria referring to the nature of a relationship and another one referring to the nature of the transactions. Each group of criteria is divided into sub criteria and several specific criteria are described for each of these sub criteria, so the full list of criteria is structured around these three levels (group of criteria, sub criteria, and specific criteria).

I. By nature of relationships

There are several attributes of the nature of relationships between counterparties, which, taken separately or in conjunction, lead to presume that the participants are related parties of the bank and are not interacting on an independent way on an arm´s-length basis. These attributes are as follows:

1. Exclusivity:

1.1 No other financial institutions not related to the bank are lending to the party and the amount and type of loans do not justify it from an economic point of view (e.g.: not a mortgage for an individual to buy a house or a consumer credit).

1.2 No credit history with other financial institutions not related to the bank (including but not limited to new companies).

2. Economic Dependence:

2.1 The party performs its business activities in an economic sector where the bank or its related parties play a very significant role (including ancillary activities).

2.2 The party gets all or most of its revenues from the bank or its related parties (including, but not limited to managers and employees of the bank and its related parties).

2.3 The party has no significant economic activity or revenues (including, but not limited to, offshore and shell companies and figureheads).

2.4 The party is so interconnected to the bank or its related parties that economic failure of one or more of these would very likely imply its economic failure.

2.5 The party acts as a nominee mostly for the bank or its related parties.

3. Common Infrastructure:

3.1 The party has common or very close business addresses and locations (physical or virtual) with the bank or its related parties.

3.2 The party has common operational structural elements, such as IT systems and accounting, with the bank or its related parties (including outsourcing).

3.3 The party has common managers or staff with the bank or its related parties.

3.4 The party has common legal advisors with or powers of attorney conferred to or by the bank or its related parties.

3.5 The party has common suppliers, services providers, or customers with the bank or its related parties.

3.6 The loan officer of the bank for the party is also the loan officer for other related parties.

4. Lack of transparency:

4.1 The ownership structure of the party is not transparent and/or its ultimate beneficiary owner is not known or disclosed.

4.2 The ownership structure of the party is unnecessarily complex.

4.3 The party is not cooperative with the National Bank of Ukraine in terms of clarifying if its relationship with the bank and its related parties goes beyond the single fact of being a borrower.

4.4 The country where the party is incorporated is not the same as where its main activity is located (including offshore companies) without economic or financial reasons for this.

II. By nature of transactions

There are several attributes of the nature of transactions between counterparties, which, taken separately or in conjunction, lead to presume that the participants are related parties of the bank, as these transactions would not be normally conducted between independent parties on an arm´s length basis. These attributes are as follows:

1. Purpose of the Transaction and Use of Funds:

1.1 The purpose of the transaction or the use of the funds does not correspond to the typical economic activity of the party (stated business).

1.2 The funds are not used for the stated formal purpose.

1.3 The funds are used, directly or indirectly, by related parties of the bank or in its interest (including but not limited to repayment of loans to other financial institutions, assets purchases, and payments of services).

1.4 The use of the funds is not known or properly controlled.

2. Documentation:

2.1 Essential elements of the general documentation of the transaction are missing or not available (including lack of documentation).

2.2 The available documentation does not reflect the real characteristics of the transaction.

2.3 The available documentation does not fit the specific needs of the transaction.

3. Underwriting Standards:

The transaction would not have been made in those terms by a diligent third party bank (good banking practices), including, but not limited to the following situations:

3.1 Some underwriting standards are not present or are defined in an incomplete way.

3.2 The amount of the loan extended does not correspond to the scope of the debtor's activity.

3.3 There is a material disproportion between proceeds, tenor, terms, and conditions.

3.4 Transactions, the legal form whereof, differs from their economic essence.

3.5 Parties have a contractual relationship involving the right to refuse their commitments to the bank (performance of determined conditions) and/or debt transfer to the bank's related party.

3.6 Establishment of individual terms and conditions of debt repayment for the debtor/counterparty, which differ from the current market conditions.

4. Indebtedness and Creditworthiness

The amount of the loans would not have been granted to the party by a diligent third party bank (good banking practices), including, but not limited to the following situations:

4.1 The loans cannot be expected to be repaid in time and form given the party creditworthiness and its available repayment sources (e.g.: loan amortization compared to regular income for individuals and to average EBITDA for corporate).

4.2 It cannot be expected that the loans can be repaid in time and form from the proceeds of the investment of the funds lent.

4.3 The credit rating (or the investment quality) of transactions are below the minimum considered acceptable by the bank.

5. Internal Controls

Internal controls over the transaction are weaker than those applied to similar transactions, including, but not limited to the following situations:

5.1 The transaction was approved through a procedure different from the procedure specified by the bank for similar counterparties.

5.2 There is no well-grounded opinion of the Risk Department or it is a negative opinion.

5.3 The amount of the loans granted and the guarantees provided by the bank significantly exceed the internal limit fixed for that kind of counterparties without any sensible economic reason for it.

5.4 The assets sold or the services provided to the bank by the party cannot be identified or there is no evidence they even existed at the time of the transaction.

5.5 The collateral received by the bank has not been appraised or registered in accordance with the internal procedures for similar transactions with third parties.

5.6 Loans granted to the party are not classified as problematic when they should be (including loans purely formal restructurings) or loan loss provisions are not properly calculated.

5.7 Bank's undue delay and postponement of implementation of the procedure for loan debt collection and collateral foreclosure.

6. Interest Rates, Fees, and Prices

6.1 Loans and other lending: Interest rates and fees to be paid to the bank are substantially lower than those of clients with similar economic and financial characteristics.

6.2 Deposits and other borrowings: Interest rates and other amounts to be paid by the bank are substantially higher than those of clients with similar economic and financial characteristics.

6.3 The prices used to sell assets and/or provide services by the bank to the party are significantly different to those prevailing in the market.

6.4 The prices used to buy assets and/or receive services by the bank from the party are significantly different to those prevailing in the market.

7. Collateral and Guarantees

7.1 Collateral or guarantees are provided by the bank or any its related parties to the party or the bank or any its related parties get collateral or guarantees from the party.

7.2 Provided collateral and guarantees are less or lower than those required for similar transactions (including not requiring collateral or guarantees at all)