

Martín Redrado: Financial stability and the importance of AML/CFT supervision and regulation

Speech by Mr Martín Redrado, Governor of the Central Bank of Argentina, at the FIBA Annual AML Compliance Conference, Miami, 13 February 2007.

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All of us in this room share a vision about the need for regional integration. Efforts include forums like this one for discussion about opportunities and shared challenges in different spheres of action at the regional level. In my view, these efforts represent an effective mean of adopting international standards and adjusting them to the realities of the continent. Regional agreements are extremely valuable as a way of consolidating the implementation of a uniform set of best practices.

For those of us who, on top of being central bankers, are also bank supervisors, we must increase our efforts to incorporate the advantages of international standards, with the fundamental addition of a regional perspective. This means a thorough knowledge of the reality of each region to take into account the factors that affect its dynamic.

Regional realities evolve, and regional demands do not necessarily match the original design and development of international standards.

Let me give you a practical example: as an international standard, consolidated supervision has existed for over thirty years. The situation with quantitative supervision is pretty much straightforward: standards are uniformly and widely applied. However, there are gray areas on qualitative supervision (that is the impact on risks of related non-financial activities), where standards are just being developed and, therefore, the implementation as a tool for supervision is under debate.

Another concrete case is the implementation of the Basel II Accord on capital requirements, particularly on how to compute capital requirements for operational risk (that is the risk of loss resulting from inadequate processes and systems, or from external events).

We have dedicated sizable resources to managing market and credit risks, and those were well-known, narrowly-defined. Operational risk was anything but well defined since there is a lot of disagreement about the specific contingencies that should be considered under this umbrella.

In the basic approach banks must hold capital for operational risks equal to the overall average over the previous three years of a fixed percentage of annual gross income. Now, in the standardized approach, banks' activities are divided into several business lines: corporate finance, sales & trading, retail banking, commercial banking. Operational risks should be considered for these particular lines of business.

In Latin America, stress tests determine relatively high regulatory capital charges for operational risk, based on the alternatives foreseen in the new capital accord. In my opinion, the operational risk measure, as it is proposed, does not necessarily reflect our risk of operations. As a consequence, we are working on developing a better measure to reflect operational risk appropriately in Latin America.

This, again, in no way implies concerns about the soundness of the international standard proposed by the Basel Committee. On the other hand, it shows a clear commitment to its application: to identify, understand, measure and mitigate risks, at the same time as it also evidences a thorough awareness of the particular situation of our financial systems.

These examples provide a framework for introducing the key issue in our discussion today, which is our vision on Latin America's agenda for fighting against AML/CFT.

We support all initiatives intended to combat money laundering and terrorist financing. Nevertheless, any counter-terrorist effort, whether through regulation, control or the gathering of information, that is applied without understanding the idiosyncrasy of the region would be counterproductive.

We cannot ignore that the US Patriot Act is a legitimate and valuable instrument to fight against these global crimes that affect our values and have become a threat to sustainable economic growth. However, by not specifying what appropriate performance with "due diligence" means, it has increased

the cost of opening and maintaining correspondent accounts, and this has affected heavily the financial systems of the region and the smaller institutions in particular.

This is reflected in the number of correspondent accounts closed in recent years. In the case of Argentina, for instance, over 200 correspondent accounts were closed between March 31, 2001 and September 30, 2005. In this period, almost fifty financial institutions, both public and private, experienced closure of correspondent accounts. Not one case showed a situation of AML or CFT. Something along the process is flawed. Within the context of our analysis of the situation in the region, we have surveyed the impact of regulations on correspondent business in Latin America with similar results.

This outcome has nothing to do with the objectives pursued by standards that combat global crimes. On the contrary, should this trend persist, it will result in growing informality within financial circuits, greater political reluctance to cooperate, and a diversion of financial channels towards other more realistic markets.

The challenge is always the same: to ensure that those actions designed to combat and prevent crimes, in addition to being well designed, are also effective.

One necessary condition for the success of a policy is relying on an evaluation that correctly describes the existing situation. The absence of this condition could mean that the proposed objectives are not met, or could even introduce additional distortions, leading to outcomes that are the opposite of those desired.

This is not a minor challenge: reality is a complex synthesis of an almost countless conjunction of causes, where history, economic and social factors clearly stand out. The challenge lies in the fact that these conditioning factors are structural in nature and are thus, by definition, difficult to modify over the short-term.

A second relevant feature of an effective policy (thoroughly tested over the course of history) is building consensus. Policies cannot be imposed in an authoritarian manner or imported from other countries. They should be endogenous to each society as a result of collective decisions with the participation of social groups with different tasks and preferences.

Such a collective decision-making process may take longer but policies designed and implemented by "conviction" rather than by "obligation" or "necessity", and with a degree of consensus, significantly improve their odds for success, and persistence over the long-term.

We are therefore working to carry out a suitable, detailed diagnosis of the current situation in Latin America as a way to cooperate in developing a specific set of rules and regulations in this subject. We have found that one of the recurring features of our economies - and Argentina is not an exception - is the high level of informality, evidenced in various ways, such as tax evasion, smuggling, capital flight, black markets, among others.

Making it clear that we must never give up the fight to bring economic activity into the formal circuits, it must be recognized that the consequences of these features are conclusive: high informality prevents a linear implementation of recommendations and best practices, which, in turn, leads to high reputational risks.

In our particular case, from the Central Bank of Argentina, we have made adjustments to regulations on money laundering, and have introduced specific new rules on the prevention and control of terrorist financing.

Although the framework in place is in line with international standards, we have considered that our "traditional" regime for the prevention of money laundering could not easily be adapted to combating terrorist financing. We know that there are significant differences that have an impact on the monitoring and information systems of financial institutions.

In addition, we have established a specific mechanism for supervision and control over the units developed for combating money-laundering and terrorist financing. This is based on the work of a team of dedicated inspectors exclusively assigned to these tasks, and a rating system for the internal control units of each financial institution.

Furthermore, recognizing the importance of developing regional standards and best practices, we are working towards the design of a regional view specifically on AML/CFT supervision.

We would like to generate renewed emphasis to the implementation of the surveillance mechanisms that already exist in the region, such as the new mutual evaluation methodologies of the FATF and GAFISUD, the multilateral evaluation mechanism of the CICAD/OAS, the IMF's Article IV, the FSAP, and the due diligence established by the US financial system in its commercial and correspondent banking relations with Latin American banks.

In the global economy, financial systems have changed in such a way that our approach to prudential regulation is always scrutinized. Traditional regulation and banking supervision mechanisms have become obsolete. Modern approaches, rather than establishing limits, place greater emphasis on requiring financial institutions to improve analysis of internal risks, management and control systems.

They require us to seek evidence of sound risk management and adequate control systems within the financial institution itself. For this reason a uniform and a reasonable criteria to ensure the effectiveness of results on the basis of the application of these standards must be urgently defined.

Our initiative with regard to specialized AML/CFT supervision could be implemented at the regional level. Let me be very clear: we are not attempting to replace the standards that have already been agreed. On the contrary, the actual aim is to supplement such recommendations with a mechanism for banking supervision that provides support to the actual implementation of those standards.

Our vision contains four central pillars: regulation, specialized supervision, ratings and information sharing.

We consider that a uniform regulatory framework should be applied, based on the existing standards, such as those established within the framework of the FATF.

To do so, it would be key to define a methodology to measure the levels of informal economic activity in Latin American economies. An annual indicator to track informality levels in our economies and other indicators for monitoring both unregistered activities and under-registered activities is critical. This kind of tools would enable us to develop proposals for action geared towards Latin American financial systems that contribute to reducing such informality levels in the medium term, with the support of multilateral agencies.

The second pillar is specialized supervision, that is to say the application of specific AML/CFT-oriented approach based on inspection programs according to a risk matrix, carried out by a qualified team of inspectors. There are no specific international standards on this matter. All the principles and recommendations mention supervision as the core component of prevention, but we are still in need of a standardized methodology.

The third pillar is rating. We believe that specific rating mechanisms developed by local supervisors should be implemented, on the basis of an agreement on aspects such as components to be rated, and the rating systems applicable to financial institutions.

Although traditionally we have rated financial institutions mainly according to liquidity and solvency considerations in order to protect the stability of financial systems, we consider that rating banks on the basis of compliance with aml/cft regulations will be relevant.

The last pillar concerns information sharing. Guidelines for the use of information and to which extend it may be shared should be defined. All of this, with special emphasis on the analysis of the legal frameworks of the different jurisdictions.

Standards with these features would allow to enhance awareness of financial systems on AML/CFT matters, providing them with a credible and stable framework for conducting their businesses and, in addition, for developing a valuable flow of information that can be exchanged between private sector parties and between the private and the public sector.

This supervision methodology, in the process of being implemented in Argentina, includes technical assistance from international institutions such as the World Bank.

Our vision is fully consistent with the risk-based approach that allows financial institutions to focus their resources on those operations, transactions, customers and accounts that show greatest vulnerability to global crimes. These approaches -already adopted by countries such as the United States- are included in several of the regulatory aspects proposed by the US Patriot Act, and are in line with the spirit of many of the recommendations of the FATF.

The risk-based approach recognizes that the banking business has peculiarities linked to cultural and historical matters associated with each region. Therefore, any regulatory framework must be flexible

enough to be able to ensure certain discretion to member countries, being applied on the grounds of their knowledge of their own banking and financial practices.

There is no unique solution or pre-established methodology for governments or international institutions to define the nature and content of a risk-based approach. Nevertheless, certain principles have been developed, describing basic concepts, which serve as a guide to develop and implement a system that can operate reasonably. However, specific aspects must be developed by the institutions on the basis of the particularities of each case.

Standards that, for example, break down risk into three vectors - country risk, customer risk and service risk- should be used universally, but the specific weight assigned to each of these components when evaluating global AML/CFT risk must be based upon the strategy pursued by each country's regulatory authorities, who best know the domestic market. This includes the periodic review of strategy by the regulator and by each financial institution.

Although standards are important, no less important is the value of the judgment by those responsible for supervision and control. For instance, what magnitudes are we discussing when analyzing fluctuations in the current account balances or the size of certain transactions? What level of volatility is unusual for a certain type of business or customer? The answer is not the same for Turkey, Russia or Argentina.

The risk-based approach, like the spirit of our proposal, tells us that these kinds of assessments require acquiring special expertise on the nature of the business that should also include thorough knowledge of standard domestic market practices. This includes not only regulatory and market issues but also elements such as corporate governance, relations with the community, and the economic, historical and cultural context. As a matter of fact, we would like to reiterate our strong support to work together with the US treasury to make the most out of the Cartagena Meeting as part of the private sector dialogue initiative.

We all know that cash-intensive activities by definition carry a greater associated risk. Nevertheless, their treatment should take into account whether the economy is in itself highly dependent on the use of cash, given the historically low penetration by financial services. Elements such as these are essential when it comes to adequately allocating risk to a customer or a transaction, and will undoubtedly increase the ability to detect criminal operations efficiently. Once financial institutions have detected through their risk analysis processes those transactions or customers showing high levels of risk, they must implement the necessary internal control measures.

Obviously this type of approach should be supplemented by a smooth and constant flow of appropriate information from the various government entities to the financial system's supervisors regarding those actions that could be linked to terrorist activities. In this instance, the timing of the availability of the relevant information will be essential to be able to act upon, particularly in the case of the fight against terrorism, when the funds used do not necessarily derive from illegal or criminal activities.

In our opinion, an approach of this nature has a positive effect on financial stability and minimizes the negative externalities associated with specific issues that can become systemic problems.

To sum up, we share the goals and we would like to contribute to meet these objectives. This is why we suggest policies that contribute to acquire a better understanding of the field as a way to reduce uncertainty and increase the effectiveness of our existing programs.

It is time to outline our experience, our knowledge, and put our organizations to work to implement concrete results to develop standards and better practices at regional level. It will contribute to the stability and sustainable development of our financial systems and our economies.

After this meeting, I am invigorated to keep working on the effective implementation of AML/CFT policies with the same dedication, the same commitment, the same energy in my country and in Latin America. My deepest belief is that only with a responsible and realistic contribution of regulators and the private sector we will succeed in giving ourselves the chance to live in better countries, better regions and a better world.

Thank you very much.