



VIII

Cross-Border Supervision of Banks

This chapter discusses international aspects of maintaining banking soundness. It identifies some of the key problem issues in supervising banks and banking groups with cross-border operations, that is, the location of the home supervisor, licensing of internationally active banks and their establishments and affiliates abroad, cross-border compliance with prudential standards, information flows, inspections, cross-border remedial action, shell banks and parallel-owned banks, international financial conglomerates, and international bank liquidation.

Evolution of Best Practices

The key challenge for supervisory authorities of internationally active banks has been to ensure that no activity of these banks escapes effective supervision and that coordinated remedial action can be undertaken when necessary. These challenges have become more salient over the past few years. Banks in industrialized countries have expanded their business into emerging and transitional economies, using their comparative advantages in producing and distributing financial services. Banks in emerging and transitional economies have, but to a much lesser extent, expanded their activities in the industrialized countries, other emerging-market countries, and offshore banking centers as they attempt to meet the competition from the major banks and take advantage of increased opportunities made possible by the relaxation of domestic regulation.

The cross-border expansion of banks can be expected in general to increase the efficiency of global capital markets, as the entrance of highly rated foreign banks frequently spurs competition among the domestic banks. However, cross-border expansion can create a variety of difficulties for supervision. This is particularly true for emerging market countries that are still developing their accounting or legal systems, and where supervisory resources are limited. First, as evidenced by the well-known case of BCCI and the lesser-known case of the Meridien International Bank, the creation of various types of corporate structures across international borders can be used to escape regulation and effective supervision. Second, the growing ability of and propensity for banks to shift their activ-

ities to offshore tax havens present a channel whereby domestic prudential regulations can be easily circumvented. Third, when accounting practices are relatively unsophisticated and disclosure laws are limited, cross-border transactions can be used to conceal problems at domestic financial institutions by booking problem assets with subsidiaries or other offshore entities. Finally, offshore transactions can be used to facilitate or commit outright fraud. Incentives for prudent behavior are varied across different jurisdictions, leading some institutions to seek out countries in which high-risk activities go unnoticed.

The circumvention of domestic prudential regulations, in particular underreporting of nonperforming assets through offshore entities, increases the risks taken by the bank or banking group as a whole and implies that bank capital may be insufficient. Fraudulent activities that are hidden by relocation to underregulated cross-border establishments create losses that will ultimately have to be borne domestically. While supervising banking establishments across borders can be difficult and strain meager resources, the cost of not adequately doing so could, in the end, be greater.

Basic principles and standards on a number of aspects of supervision and regulation of cross-border banking have been developed by the Basle Committee on Banking Supervision, starting with the so-called Basle Concordat in 1975 (see Basle Committee, 1975 and 1983). Implementation of the principles in the Concordat was for many years on a best endeavors basis. Following the BCCI failure, the Basle Committee issued its "Minimum Standards" in 1992 (see Box 7), underlining and further developing some of the main concepts of the Concordat with regard to cross-border supervision (see Basle Committee, 1992). To implement the standards, a number of countries have concluded bilateral exchanges of letters or signed Memoranda of Understanding.¹²¹ Subsequently, a working group of the Basle Committee and the Offshore Group of Banking Supervisors is seeking to resolve a number of issues relating to the implementation of the minimum standards, and has recently

¹²¹See the Office of the Comptroller of the Currency (1996), for example, describing supervisory agreements between the United States and Germany.

Box 7. The Basle “Standards”

In 1992, following the closure of BCCI, the Basle Committee reformulated the principles behind the Concordat into minimum standards that G-10 supervisory authorities undertook to observe. They subsequently invited other supervisory authorities to do so as well. The standards are as follows:

- All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision.
- The creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank’s and, if different, the banking group’s home-country supervisory authority.
- Supervisory authorities should possess the right to gather information from cross-border banking establishments of the banks or banking groups for which they are the home-country supervisor.
- If a host-country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

issued a set of recommendations to supplement the minimum standards.¹²²

Current Status of Best Practices

This section discusses contacts and cooperation between a home and a single host supervisor based on the principles mentioned above.

Location of the Licensing and Lead Supervisory Authority

A home-country supervisory authority is responsible for supervising the global operations of a bank or banking group, on the basis of consolidated and verifiable financial and prudential information. This approach encompasses not only a bank holding company’s or parent bank’s direct branches and subsidiaries, but also includes any significant nonbank companies and financial affiliates.

The home country should also be the location of the senior management and the bulk (the majority of the consolidated balance sheet total) of a bank’s business. If the majority of the activities appear to be conducted

elsewhere, it would become difficult for the home supervisor to fulfill its obligations, and arrangements should be made with another country involved to take on the role of home supervisor. The case of BCCI, where the licensing authorities for the two parent banks could only supervise a very minor part of the group’s activities, as the bulk was conducted in other jurisdictions, has illustrated the necessity of this approach.

Licensing of Internationally Active Banks

Home and host authorities should both give their explicit permission for the setting up of an establishment abroad (see Basle Committee, 1992). The home authority should be able to refuse the establishment of a branch or subsidiary of a bank jurisdiction, suspected to be inadequately regulated. In addition to applying normal licensing procedure to a foreign bank, home- and host-country authorities should also consider the bank’s and banking group’s organization and operating procedures for the management of risks, internal controls, and audits, on both a domestic and cross-border basis. In judging these criteria, a host-country authority should be particularly concerned with the level of support that the head office or parent is capable of providing to the proposed establishment.

Before granting consent to the establishment of a cross-border establishment, the home and host authorities should each review their supervisory responsibilities with respect to the establishment. If either of the authorities has any concerns about the division of responsibilities, then that authority has the responsibility to initiate consultations with the other authority so that they reach an explicit understanding on which one of them is in the best position to take primary responsibility either generally or in respect of specific activities. A similar review should be undertaken by both authorities if there is a significant change in the bank’s or banking group’s activities or structure.

International Implementation of Prudential Standards

The home-country supervisory authority has responsibility for supervising the bank or banking group on a consolidated basis, domestically as well as internationally. The home supervisor will also need to take account of the fact that capital cannot always easily be moved from one part of a banking group to another across international borders. Host countries are primarily responsible for the liquidity of a foreign establishment, since they will be better equipped to assess liquidity as a function of local market conditions and practices and the establishment’s position in the market.¹²³ But they will also be responsible for the sol-

¹²²See Basle Committee (1996c). Also included in the Basle Committee’s *Compendium of Documents* (1997b).

¹²³See Basle Committee (1983).

veny and supervision of subsidiaries. The Basle Concordat and its subsequent amendments and additions set out the respective responsibilities of host and home authorities. Host authorities are responsible for the foreign bank establishments in their territory, and home-country authorities are responsible for these establishments as parts of larger-scale activities of banks under their supervision. Notwithstanding a certain division of labor, home and host authorities need to be in close contact and cooperate effectively.

Cross-Border Supervisory Information

Home country supervisors have the right to gather information from their cross-border banking establishments. Host authorities should be able to obtain any necessary information from the home authority. This ability to gather information should be a condition for giving consent for the cross-border establishment of a bank, although appropriate safeguards for confidentiality are necessary. Any undue impediments in the home and the host country in the area of bank secrecy and confidentiality to the exchange of supervisory information between banking supervisory authorities should be removed (see Basle Committee, 1983). At the same time, legal arrangements need to be in place to safeguard the information that has been exchanged, especially relating to depositors', creditors', or investors' names, against disclosure to third parties. Local supervisory authorities should provide access to the local establishment of a bank to auditors of the head office or parent corporation and be willing to discuss the affairs of the local establishment with the auditor.

The information to be shared should include both quantitative and qualitative aspects, including balance sheets, income or profit and loss accounts, information on shareholders and management, internal control systems, internal audit, external auditors' reports, prudential reports, and any other information that can be considered necessary for the proper exercise of supervision.¹²⁴ The information should permit the supervisors to calculate the bank's (or banking group's) capital adequacy ratios, large exposures or legal lending limits, and funding and deposit concentrations on a consolidated basis. Even if from an accounting point of view full consolidation is technically not possible, the home and host supervisors should be able to verify the network of the bank's other affiliations or branches, financial or nonfinancial, as well as the transactions between these entities. Home and host authorities will need to be aware that prudential standards and supervisory practices may differ between countries.

¹²⁴See Chapter IV for a complete discussion of the information requirements for supervisors.

Information on individual clients of a bank will typically have the highest degree of confidentiality protection. Such information will be required when assessing asset quality and credit files may need to be examined. However, when a supervisor detects a serious crime during an inspection or analysis of off-site data, law enforcement agencies and the supervisors in other countries involved should be informed as quickly as possible. Information on substantial changes in strategy, ownership, financial situation, or any problems in establishments abroad, head offices, or parent banks should be communicated immediately to the other supervisory authorities involved.

Cross-Border Inspections

Authorities of the host state should permit on-site inspections by the home supervisor of a prudential nature¹²⁵ of establishments of internationally active banks within its jurisdiction. Together with the free flow of data, such inspections are a necessary corollary of effective consolidated supervision.

The conduct of on-site inspections on the territory of another state requires the consent of the country receiving the inspection team. Any legal barriers against such on-site inspections would need to be removed, for instance by concluding agreements between countries on the conduct of such inspections. Such agreements should preferably be multilateral in the case of banks active in several jurisdictions. If legal impediments exist in the interim, host supervisors should be willing to cooperate to the fullest extent possible, within the limits of their laws, with any home supervisor that wishes to make an inspection. This can be facilitated by allowing the host supervisor the option to accompany the home supervisor throughout the inspection.

Operational aspects of cross-border inspections would typically need to be agreed upon in advance by both authorities. For this, standardized arrangements could be made between the supervisory authorities.¹²⁶ The findings of inspections should be shared between the supervisory authorities of both countries, as well as with the institution involved.

Supervisory Action Against Establishments Abroad

When inspections or other information would indicate the need for remedial or punitive action, this may be complicated by differences in the legal arrange-

¹²⁵In some countries, on-site inspections are used to verify compliance with nonprudential rules and regulations, such as taxation laws; inspections teams often include, for example, investigative staff of taxation authorities and law enforcement agencies.

¹²⁶See, for instance, the supervisory arrangements between the United States and Germany described in Office of the Comptroller of the Currency (1996).

ments. Supervisory authorities in different countries should therefore conclude arrangements to make supervisory action in the foreign state possible, should the need arise. These arrangements could also include providing assistance in accessing local nonsupervisory information, for example, on the legal system, on shareholders' activities, and in obtaining good legal counsel.

Branches abroad are the responsibility of the head office. Therefore, the home country supervisor can require the management at the head office to remedy deficiencies in the branches, and apply the full range of legal instruments against the head office to achieve this result. Subsidiaries should also be subject to consolidated supervision, but are subject to the jurisdiction of the host state. The parent bank is likely to have considerable influence and its home supervisor may use this influence to induce improvements.

Information on Supervisory Systems and Structures

A host state should be able to ascertain whether the home state can "capably perform home country consolidated supervision" (see Basle Committee, 1992) as a condition for permitting an establishment of a foreign bank entry to its territory. If the host supervisory authority is in any doubt in this respect, it should either refuse entry, or stipulate that the establishment shall be supervised on a strict "stand-alone" basis. The host and home authorities should in any case be well aware of each other's supervisory systems and practices. The supervisory authorities of both states should exchange complete information on each other's banking laws, the scope of their respective authorities, and prudential regulations applicable to the establishment on their territory. The supervisory authority should have adequate powers to obtain the necessary information, including regular financial reports and prudential reports. The quantity and quality of available resources to supervise the foreign operation should be assessed, as well as supervisory techniques, frequency of inspections, et cetera. These items should provide the basis for a judgment as to whether the supervisory authority is capable of performing consolidated supervision. It is also important to establish the track record of the other supervisory authority in taking effective supervisory action against banks, especially those with establishments abroad.

To facilitate the process, a system of routine personal contacts should be set up between supervisors of the host and home countries, including the exchange of names, addresses, and information on language and other skills. Such information is crucial for building a good and effective working relationship between both authorities and for taking action when necessary. It will greatly facilitate many of the aspects of cross-border supervision as described above.

"Shell Banks" and Parallel-Owned Banks¹²⁷

The authority that licenses a so-called shell bank, defined here as a loan generation or booking office, licensed or registered in one center but effectively controlled or managed from another jurisdiction, has responsibility for supervising the shell bank. To be effective, no shell bank should be licensed if the head office in another jurisdiction is not subject to adequate banking supervision on a consolidated basis. When a license is requested for a shell bank, the supervisory authority needs to establish contact with the home supervisor of the bank or its parent bank and ascertain whether permission has been granted to open the office abroad. Only when all necessary information on the bank and on the quality of home-country supervision is obtained and found satisfactory can the application be approved.

The home supervisor needs to be allowed to inspect the books of the shell bank wherever they are kept, and in whatever form, in order to establish whether banking activities are undertaken and whether the risks are adequately controlled by the head office. If the home supervisor is not allowed to conduct an inspection, it cannot authorize the shell bank to be established. If, subsequent to its opening, the home supervisor is unable to satisfactorily inspect the books, the shell bank must be closed.

Parallel-owned banks, where a bank in one jurisdiction is under the same nonbank ownership as a bank in another jurisdiction, are more problematic and need to be kept under close scrutiny. If the nonbank owner has as its sole activity the ownership of one or more banks, the owner ought to also be subject to the consolidated banking supervision of a single banking supervisory authority, notwithstanding the separate responsibility of the supervisory authorities in the respective individual countries. In the absence of such an arrangement, it will be necessary for the respective supervisors to prevent sources of contagion, for example by particularly rigorous connected lending rules.

International Financial Conglomerates

The problems illustrated above become even more salient in the case of an internationally active financial conglomerate. Supervisors over conglomerates active in several financial sectors need to establish close contacts and make practical arrangements for the exercise of supervision. A financial group, incorporating banking, securities, and insurance subsidiaries and other financial intermediaries, can be subject to three or more different regulators and regulatory regimes. At the domestic level, this already poses significant problems of coordination, information, and compliance with

¹²⁷See Basle Committee (1996c).

prudential regulations. These problems are compounded at the international level, where the problem of coordination, information, and compliance potentially involves several regulators for each country in which the conglomerate is active. In such cases, some countries have found it useful to designate lead regulators to carry out a coordinating role.

The technical issues that need to be addressed in the context of international financial conglomerates have been enumerated in the Joint Forum's mandate, and consist of (1) the supervision of financial conglomerates on a groupwide perspective; (2) techniques for assessing the adequacy of capital of financial conglomerates; (3) supervisors' ability to check on fit and proper standards of managers and their ability to ensure that shareholders meet adequate standards; (4) the supervisory approach to participation of less than 100 percent in entities within financial conglomerates; (5) the supervisory approach to large exposures and to intragroup exposures within financial conglomerates; and (6) the supervisors' ability to intervene in structures that impair effective supervision.

International Bank Liquidation¹²⁸

When a bank that has a branch in another country is closed, liquidated, or declared insolvent, the supervisory authority in the country where the branch is established must immediately be informed by the home supervisory authority. The host authority would then promptly close the branch. Any additional liabilities incurred by the branch, for instance, would fall within the estate of the closed bank. Subsidiaries are legally separate from the parent bank. Their assets and liabilities

in theory remain unchanged when the parent bank closes. However, there is an increased risk of uploading or downloading assets and liabilities between the closed parent and the subsidiary, which could damage the subsidiary's depositors and other creditors.

Ideally, bank liquidation takes place on the basis of a single set of rules. In practice, international bank insolvencies are extremely complicated, as some countries follow the separate-entity approach and are able to place their depositors and creditors before those of other countries, irrespective of liquidation law in the other country, whereas other countries follow the single-entity approach, which considers the bank as a whole and gives equal treatment to all creditors wherever their domicile and whether their claim is on a domestic or foreign branch. These are issues that cannot be solved by supervisors, even when the outcome is relevant to the proper execution of their task. In the light of the greater internationalization of banking activities and the potential international impact of such liquidations, further international harmonization of insolvency rules for financial institutions is desirable.¹²⁹ Work on international insolvency law is being undertaken by the United Nations Commission on International Trade Law (UNCITRAL), and recently a draft document of the Group of Thirty was issued on international insolvencies of financial institutions.¹³⁰ It is essential that supervisory authorities keep each other closely informed on bank insolvencies and liquidations, and provide all possible assistance in giving foreign supervisors access to the proceedings in their countries.

¹²⁹See Basle Committee (1993), which discusses problems associated with the liquidation of BCCI.

¹³⁰Group of Thirty (1996). The European Union has for many years attempted to reach agreement on rules for the intervention in and liquidation of banks.

¹²⁸The Core Principles for Effective Banking Supervision do not address international bank liquidation.