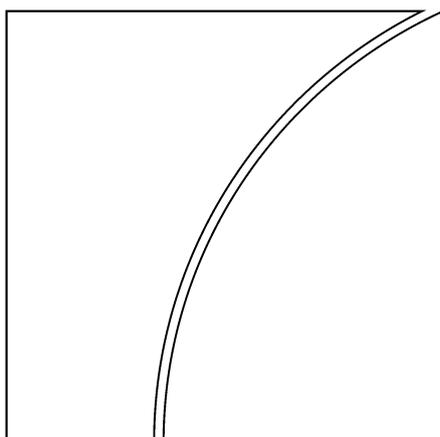


Basel Committee
on Banking Supervision



Parallel-owned banking structures

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BANK FOR INTERNATIONAL SETTLEMENTS

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Parallel-owned banking structures¹

1. Introduction

Parallel banks are defined as banks licensed in different jurisdictions that, while not being part of the same financial group for regulatory consolidation purposes, have the same beneficial owner(s), and consequently, often share common management and interlinked businesses. The owner(s) may be an individual or a family, a group of private shareholders, or a holding company or other entity that is not subject to banking supervision.² Parallel banking relationships may exist, unknown to the supervisors of the parallel banks.

Such structures may be established for a variety of reasons, among others: to take advantage of different tax arrangements; to avoid legal restrictions in some countries on the ownership of foreign subsidiaries by domestic banks; or to diversify risk outside countries that are considered economically or politically unstable. In some cases, the motivation may be an attempt to evade regulatory constraints or consolidated supervision from the home country.

Even though a close relationship may exist between the parallel banks, they are not members of a defined banking group that is subject to consolidated supervision. Consequently, parallel-owned banking structures present greater risk for supervisors who may be unaware of the nature and extent of any relationships and transactions between the banks that may have an impact on its safety and soundness. This opaqueness may also provide an incentive to the controllers to use the banks to provide undisclosed support mechanisms or to mask the true risks within the group. Finally, problems encountered in one bank may cause a loss of confidence in the parallel entity, even if there are no transactional links.

Given the supervisory issues that may arise with parallel-owned banking structures, there is a presumption that in principle such structures should not be permitted and this has been the Committee's attitude over recent years since the failure of BCCI.³ This paper sets out supervisory guidance for dealing with parallel banks.

¹ This paper was prepared by the Working Group on Cross-border Banking, a joint group consisting of members of the Basel Committee and of the Offshore Group of Banking Supervisors.

² This definition is not meant to cover the category of large corporate groups which include banking subsidiaries located in different countries when the main activity of such groups is not financial, groups for which consolidated supervision would not be appropriate. In this case, proper supervision arrangements and the legal framework governing flow of information should be put in place in order to coordinate the supervision of the different financial entities of the group.

³ The first of the *Minimum Standards* states "All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision." To meet this standard, the home country supervisory authority should, among other things, "have the capability to prevent corporate affiliations or structures that either undermine efforts to maintain consolidated financial information or otherwise hinder effective supervision of the bank or banking group" (*Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments* (1992, page 3).

2. Identification of parallel-owned banking structures

The characteristics listed below are indicators that a domestic bank may be directly or indirectly controlled by a person or group of persons that also controls a foreign bank through a parallel structure. If a bank exhibits one or more of these characteristics, the supervisors should conduct additional inquiries to ascertain whether a parallel-owned banking structure is in fact in place:

- An individual or group of individuals acting in concert that controls a foreign bank also controls any class of voting shares of a domestic bank; or financing for persons owning or controlling the shares is received from, or arranged by, a foreign bank, especially if the shares of the domestic bank are collateral for the stock purchase loan.
- A domestic bank has adopted particular or unique policies or strategies similar to those of a foreign bank, such as common or joint marketing strategies, sharing of customer information, cross-selling of products, or linked websites.
- An officer or director of a domestic bank either serves as an officer or director⁴ of a foreign bank, controls a foreign bank, or is a member of a group of individuals acting in concert or with common ties that control a foreign bank.
- There is an unusually high level of reciprocal correspondent banking and other facilities between a domestic bank and a foreign bank.
- The name of a domestic bank is the same as or is similar to that of a foreign bank.

3. Supervisory concerns

The importance of effective global consolidated supervision of a banking group is emphasised in the Basel Committee's *Concordat* (1983), *Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments* (1992), *Supervision of Cross-border Banking* (1996) and *Core Principles for Effective Banking Supervision* (1997). Each of these documents emphasises the need to have adequate information flows to enable the home supervisor to monitor the group on a global basis.

With a parallel-owned banking structure, there are two or more “home” supervisors, but none of these supervisors performs consolidated supervision of the entire banking group. It is not feasible or practical to require any supervisor acting alone to gather the necessary supervisory information on all related foreign parallel banks in the group, especially if parts of the organisation structure in foreign countries are opaque. This makes it difficult for a supervisor to apply prudential norms to its domestic bank, without an understanding of how it will be affected by the overall financial position and risks of the entire banking group.

The particular risks associated with parallel-owned banking structures stem primarily from the possibility that officers or directors of one of the parallel banks will expose the bank, either intentionally or unintentionally, to higher risks through transactions with related parallel banks. There is a risk that transactions may not be conducted at arms-length, or that the relationship may be used to fabricate the financial position of one or more of the institutions. For instance, the following may result:

⁴ The sharing of a director, by itself, is unlikely to indicate common control of the domestic and foreign banks.

- One parallel bank may seek to evade legal and other regulatory lending limits by carrying out transactions through its related parallel bank, thereby increasing concentration risk.
- Assets, earnings and losses may be artificially allocated between parallel banks. Similarly, low-quality assets and problem loans can be shifted between parallel banks to manipulate earnings or losses and to avoid regulatory scrutiny.
- Capital can be generated artificially through the use of stock purchase loans from one parallel bank to the other. As a result, capital for one of the parallel banks is increased even though there is no external capital injection into either bank.
- One of the parallel banks may be the conduit or participant in a transaction that violates local law or the laws of a foreign country, or that is designed to benefit one of the banks, to the detriment of the other.
- One bank that experiences financial difficulties may pressure the related institution to provide liquidity or other support in excess of legal limits or prudential norms.
- Money-laundering concerns may be heightened, especially when the foreign parallel bank is situated in a country where anti-money laundering standards are not robust.

4. Creation of new parallel-owned banking structures

Parallel-owned banking structures are by their nature very difficult if not impossible for effective consolidated supervision. While it is recognised that the legislation in some countries may not allow the supervisor to reject a bank licence application simply because a parallel bank will be created, the presumption should be that where it is not possible to close supervisory gaps, applications for new parallel banks should be refused.

A number of jurisdictions have implemented legislation that permits supervisors to refuse authorisation to those banks with “unsupervisable” corporate structures or to revoke existing authorisations. Countries that have not already done so are encouraged to do so.

Factors that can lead supervisors to the conclusion that a corporate structure hinders effective consolidated supervision include:

- complexity that prevents a clear view of the entire business of the group;
- an inability to clearly identify ultimate ownership;
- group companies operating in jurisdictions where secrecy provisions limit access to information;
- significant parts of the group business being conducted in jurisdictions where supervision and regulation are weak; and
- the absence of a natural home base for the group.

Where the supervisor does not have the power in law or in practice to prevent the creation of a parallel bank, it should seek to limit the risk by minimising the supervisory gap whenever such a structure is created.

When assessing an application for a bank licence, the licensing authority should require the applicant to furnish information about the ownership structure so that it can be ascertained whether the beneficial owners already control a bank or banks in other jurisdictions. It may be helpful to require the beneficial owners to make a declaration to this effect.⁵ The supervisor should seek to understand how the bank would fit within the group structure and should obtain information about the other banking operations.

The supervisor may discuss the application with the supervisor(s) of the related foreign parallel bank(s) and seek their views. If possible, the discussion should look at how the whole structure is going to be supervised (see section 5). In granting the application, the supervisor may impose one or more of the following licensing conditions to obtain the necessary comfort that a parallel-owned banking structure is supervisable on a consolidated basis:

- enforce a change in the group structure, as indicated by the *Minimum Standards*, to facilitate more effective supervision;
- require the bank to agree to an arrangement for supervisory co-ordination discussed in section 5;
- place restrictions on the bank's ability to engage in transactions with the foreign parallel bank;
- place restrictions on the extent to which the parallel banks can establish a shared management process;
- require written agreement from the beneficial owners of the parallel banks to provide, on demand, relevant information needed for understanding the operations and risks of the entire parallel banking group; and/or
- prevent one bank from acting as a collecting agent for deposits directed towards the parallel institution.

On approval, the bank should be required to make available to supervisors for their review and examination, the following:

- the bank's policy of interaction with the foreign parallel bank(s); and
- the extent of its exposure to and transactions with the foreign parallel bank.

5. Supervision of parallel-owned banking structures

There are many parallel banks in existence and it would be impractical to propose their closure. But steps need to be taken to limit the risks posed by these entities and to ensure that they are subject to adequate supervision. Several supervisory approaches may be considered. First, a supervisor should focus on working closely with the relevant foreign supervisors to ensure a high level of cooperation and coordination in the supervision of the parallel banks. Where practicable, a lead supervisor might be appointed to supervise the structure on a consolidated basis. Secondly a supervisor should consider either forcing a

⁵ In practice, the supervisor may not always possess the full facts regarding the beneficial owners, short of establishing a clearing house system whereby all supervisors can be given the opportunity to register their interest in the beneficial owners where a parallel-owned banking structure is known to exist.

group restructuring or ring-fencing the operations of the domestic bank. Ultimately, however, it may be necessary to bring about closure of the domestic bank, if a satisfactory supervisory regime cannot be implemented.⁶

Close cooperation between supervisors

A key mechanism to consider in the supervision of parallel-owned banking structures is having supervisors work together to ensure adequate understanding and oversight of the entire group. There should be willingness of the foreign supervisor to cooperate and share information cross-border on the conditions of the bank and its compliance with banking laws and regulations.

Supervisors will need certain information to assess the risk arising from the parallel bank structure. The supervisor is likely to obtain such information only by working closely with the foreign supervisor. This information includes:

- strategy, management, organisation and activities of the parallel-owned banking structure;
- inter-company and related transactions;
- adequacy of supervision conducted by the foreign supervisor, and
- political, legal, or economic events in the foreign country.

On-site examination of the domestic parallel bank should be a significant part of the supervisory programme for the parallel bank. It may be helpful for the supervisor to communicate with the supervisor responsible for the foreign parallel bank prior to an examination to find out if there are issues and concerns with the operations of the foreign parallel bank that may have a bearing on the domestic parallel bank. In any event, the on-site and off-site programme should include a specific review of inter-company and related transactions, including transactions covered by applicable regulation.

Lead supervisor

An alternative to supervise a parallel-owned banking structure is for one supervisor (ideally the supervisor of the largest business unit) to act as a lead supervisor, for supervising the structure on a consolidated basis. This arrangement has only been implemented in limited cases. Where it does come into force, it requires the agreement of fellow supervisors and the relevant institutions concerned so as to facilitate supervision by the lead supervisor who does not have jurisdiction over the foreign parallel banks.

A lead supervisor approach is not workable in many jurisdictions because:

- Legal impediments and privacy considerations may prevent the lead supervisor from accessing all necessary supervisory information from the foreign parallel banks.
- Normal supervisory procedures (especially cross-border on-site examination) may not be possible from either a legal or practical perspective.

⁶ Supervisory power to close the bank is provided under EU law.

- Depositors and creditors of the foreign parallel banks may look to the lead supervisor (and the central bank if not the same) as liquidator or lender of last resort, generating moral hazard and reputation risk issues.
- Budget issues may arise when supervisory resources are channelled to supervise and conduct inspections of foreign parallel banks that do not pay assessments to the lead supervisor.
- It may not be possible to grant reciprocal arrangements for foreign supervisors to inspect the banks in the lead supervisor's country.
- It may not be possible to grant appropriate enforcement powers to the lead supervisor over all banks in the group.

Restructuring

To mitigate the risk from the parallel bank structure on the domestic bank, the supervisor may impose a change in the group structure to facilitate more effective supervision, restrict the domestic bank's ability to engage in transactions with the foreign parallel bank, or limit joint management. It should try to impose any such restrictions at the earliest opportunity. This can be most easily done the next time the bank needs supervisory approval for any of its actions, e.g. changes in ownership.

Ring-fencing

Where the supervisor of a parallel bank concludes that there is inadequate access to information about material parts of the parallel-owned banking structure, and co-operation with the foreign supervisor will not sufficiently mitigate the risk of the parallel bank structure, it should seek to ring-fence the operations of the domestic bank. This entails limiting the exposure of the domestic bank to its related parallel banks and other members of the corporate group.

6. Conclusion

The conclusion is that parallel-owned banking structures should, in principle, not be permitted because they conflict with the Core Principles. But the supervisor may not have the power in law or in practice to prevent the creation of a parallel bank and therefore, the supervisor should seek to limit the risk by imposing conditions or restrictions to facilitate more effective supervision. For existing parallel-owned banking structures, supervision can only be properly exercised if the relevant supervisors co-ordinate closely and share information in the supervision of the parallel banks, paying attention to their special characteristics in order to minimise the supervisory gap. A lead supervisor that is willing to conduct consolidated supervision of the corporate group is an alternative, but most supervisors may not be willing or able to take on that responsibility in light of the likely absence of legal supervisory powers. The supervisor should also consider enforcing a group restructuring or ring-fencing the operations of the domestic bank. Ultimately, it may be necessary to bring about closure of the domestic bank, if a satisfactory supervisory regime cannot be implemented. The mechanics for putting these and other prudential policies in place should be clearly addressed by the supervisors' published guidance on licensing and supervisory policies.