

**The Supervision
of
Cross-Border Banking**

**Report by a working group
comprised of members of the
Basle Committee on Banking Supervision
and the
Offshore Group of Banking Supervisors**

Basle, October 1996

Preface

This document reproduces a report prepared by a working group consisting of members of the Basle Committee on Banking Supervision¹ and the Offshore Group of Banking Supervisors² which presents a number of proposals for overcoming the impediments experienced by banking supervisors in conducting effective supervision of the cross-border operations of international banks. The working group was established in order to consider a number of problems which had been experienced in the implementation of the Basle Committee's report "*Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments*" (July 1992) and to suggest practical solutions. The resulting report contains twenty-nine recommendations which are set out in Section II. These recommendations are aimed at improving and facilitating prudential supervision of banking risks with a view towards ensuring the soundness of individual credit institutions and the stability of the financial system as a whole.

The Basle Committee and the Offshore Group have endorsed the report and their members have undertaken to use their powers to work towards the implementation of its recommendations. The Basle Committee believes that the working group has made great progress in dealing with a number of difficult issues. The framework designed, if fully implemented as intended, should offer major enhancements in the supervision of multinational banking groups. However, implementation of the programme set forth in the document will have to be closely monitored, and it is possible that further changes may be needed in the future.

In June 1996, the report was discussed at the Ninth International Conference of Banking Supervisors in Stockholm attended by supervisors from one hundred and forty countries. Following detailed discussion of the contents of the report, Conference participants, in their capacity as bank supervisors, endorsed the principles set out in the report and undertook to work towards their implementation in national centres. Regional groups of banking supervisors will carry on the discussions about the implementation of the report. It is intended that a survey should be conducted in advance of the next ICBS in 1998 to monitor the progress made in overcoming obstacles to effective consolidated supervision.

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- 1 The Basle Committee on Banking Supervision is a committee of banking supervisory authorities which was established by central-bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, and United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.
 - 2 The Offshore Group of Banking Supervisors was established in 1980 as a forum for supervisory cooperation between the banking supervisors in offshore financial centres. Current members of the Group are Aruba, Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Cyprus, Gibraltar, Guernsey, Hong Kong, Isle of Man, Jersey, Lebanon, Malta, Mauritius, Netherlands Antilles, Panama, Singapore and Vanuatu.

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The supervision of cross-border banking

I. Introduction and background

The Minimum Standards for the supervision of international banking groups and their cross-border establishments, issued by the Basle Committee on Banking Supervision in July 1992, establishes four main principles:

1. All international banks should be supervised by a home country authority that capably performs consolidated supervision.
2. The creation of a cross-border banking establishment should receive the prior consent of both the host country and the home country authority.
3. Home country authorities should possess the right to gather information from their cross-border banking establishments.
4. If the host country authority determines that any of these three standards is not being met, it could impose restrictive measures or prohibit the establishment of banking offices.

At the end of 1994, a working group³ comprised of representatives of the Basle Committee and of the Offshore Group of Banking Supervisors was set up to consider a number of issues relating to the implementation of the Minimum Standards with a view to overcoming the impediments to effective cross-border supervision. Although, because of the group's composition, its discussions focused principally on the supervision of offshore banking, its conclusions are applicable to all home and host supervisory relationships and have been framed as such.

The working group believes that supervisors have the right to apply whatever supervisory techniques they commonly use on an ongoing basis in order to fulfil the Minimum Standards. However, in some cases impediments remain. The report examines the nature of these impediments and identifies practical arrangements to enable supervisors to implement the Standards, using their regular supervisory techniques. The problems in achieving this objective which the working group has identified fall into two main categories. These issues are addressed sequentially in the main body of the paper:

- (a) The first set of problems relates to the third of the Standards set out above, namely *information access*. In particular, home country supervisors ("home supervisors") either have experienced or perceive difficulties in obtaining all the information they require in

³ The members of the group were: Mr. Crook (Guernsey), Mrs. Dilbert (Cayman Islands), Messrs Feldberg/Rutledge (USA), Mrs. Foo-Yap Siew Hong (Singapore), Messrs Godano (Italy), Hartzell/Sullivan (USA), Hauri/Zuberbühler (Switzerland), Sanio (Germany), Smout/Chalmers (UK), Spillenkothen/Ryback/Schemering (USA), Williams (Bermuda), Freeland (Secretariat). The group was co-chaired by Messrs Powell (Chairman of the Offshore Supervisors Group) and Musch (Secretary General of the Basle Committee).

order to undertake effective consolidated supervision. Bank secrecy legislation remains an impediment in certain circumstances and jurisdictions. Moreover, there are still impediments in certain countries to the conduct of certain long-established techniques and procedures, including cross-border on-site inspections by home supervisors. Conversely, host supervisors also need information from home supervisors if they are to exercise effective host supervision.

(b) The second set of problems relates to the more general principle laid down in the Concordat that all cross-border banking operations should be subject to *effective home and host supervision*. In particular:

- host country supervisors ("host supervisors") have no common standard to judge what constitutes effective consolidated supervision by home supervisors and whether it is being exercised as required by the first Minimum Standard;
- in deciding how best to carry out effective consolidated supervision, home supervisors need a mechanism to assess the standards of supervision exercised by host supervisors. The Offshore Group has established minimum criteria for its members and is seeking assistance from the Basle Committee in determining whether individual offshore centres meet those criteria;
- gaps in supervision (e.g. booking offices in the form of so-called "shell branches", parallel-owned banks, i.e. "sister" institutions with common ownership, and parent institutions incorporated in under-regulated financial centres) continue to pose a threat to the principle of the Concordat that no banking establishment should escape supervision.

In moving towards effective compliance with the Minimum Standards, and with the recommendations in this document, the working group believes that the intention in the 1992 document that countries should be actively working to ensure compliance needs to be reaffirmed at the Stockholm ICBS with a positive commitment from all participants. In order to set some form of target for possible legislative changes, it proposes that the ICBS be asked to agree to review the evidence of individual countries' implementation of the Standards and the recommendations herein by means of a survey in time for the 1998 ICBS. The group observes that at some stage authorities that are unable to obtain satisfactory evidence that a specific country has implemented the Standards will decide to introduce the sanctions referred to in the Fourth Standard or to limit their banks' operations in certain overseas jurisdictions.

II. Summary of conclusions and recommendations

The working group has identified numerous conclusions and recommendations which it believes could usefully supplement the Minimum Standards. The recommendations below are submitted to the ICBS for participants' endorsement, bearing in mind that they need to be considered in the context of the sections of the paper from which they are drawn.

1. Improving the access of home supervisors to information necessary for effective consolidated supervision

- (i) In order to exercise comprehensive consolidated supervision of the global activities of their banking organisations, home supervisors must be able to make an assessment of all significant aspects of their banks' operations that bear on safety and soundness, wherever those operations are conducted and using whatever evaluative techniques are central to their supervisory process (*paragraph 16 and 18*).
- (ii) Home supervisors need to be able to verify that quantitative information received from banking organisations in respect of subsidiaries and branches in other jurisdictions is accurate and to reassure themselves that there are no supervisory gaps (*paragraph 7*).
- (iii) While recognising that there are legitimate reasons for protecting customer privacy, the working group believes that secrecy laws should not impede the ability of supervisors to ensure safety and soundness in the international banking system (*paragraph 5*).
- (iv) If the home supervisor needs information about non-deposit operations, host supervisors are encouraged to assist in providing the requisite information to home supervisors if this is not provided through other supervisory means. The working group believes it is essential that national legislation that in any way obstructs the passage of non-deposit supervisory information be amended (*paragraph 8*).
- (v) Where the liabilities side of the balance sheet is concerned, home supervisors do not routinely need to know the identity of individual depositors. However, in certain well-defined circumstances, home supervisors would need access to individual depositors' names and to deposit account information (*paragraph 9*).
- (vi) It should not normally be necessary for the home supervisor to know the identity of investors for whom a bank in a host country is managing investments at the customer's risk. However, in certain exceptional circumstances, home supervisors would need access to individual investors' names and to investment account information subject to the safeguards in paragraph 10 (*paragraph 13*).
- (vii) The working group recommends that host supervisors whose legislation does not allow a home supervisor to have access to depositor information use their best endeavours to have their legislation reviewed and if necessary amended to provide for a mechanism

whereby in exceptional cases a home supervisor, with the consent of the host supervisor, will gain access to depositor information subject to the same conditions as outlined in (viii) below (*paragraph 12*).

(viii) In order to provide legitimate protection for bank customers, it is important that the information obtained by home supervisors, especially that relating to depositors' or investors' names, is subject to strict confidentiality. The working group recommends that those host jurisdictions whose legislation allows foreign supervisors to have access to banks' depositor or investor information should subject such access (at the host country's discretion) to the following conditions (*paragraph 10*):

- the purpose for which the information is sought should be specific and supervisory in nature;
- information received should be restricted solely to officials engaged in prudential supervision and not be passed to third parties without the host supervisor's prior consent;⁴
- there is assurance that all possible steps will be taken to preserve the confidentiality of information received by a home supervisor in the absence of the explicit consent of the customer;
- there should be a two-way flow of information between the host and home supervisors, though perfect reciprocity should not be demanded;
- before taking consequential action, those receiving information will undertake to consult with those supplying it.

(ix) If a host supervisor has good cause to doubt a home supervisor's ability to limit the use of information obtained in confidence solely for supervisory purposes, the host would retain the right not to provide such information (*paragraph 11*).

(x) Subject to appropriate protection for the identity of customers, home supervisors should be able at their discretion, and following consultation with the host supervisor, to carry out on-site inspections in other jurisdictions for the purposes of carrying out effective comprehensive consolidated supervision. This ability should include, with the consent of the host supervisor and within the laws of the host country, the right to look at individual depositors' names and relevant deposit account information if the home supervisor suspects serious crime as defined in section (d). If a host supervisor has reason to believe that the visit is for non-supervisory purposes, it should have the right to prevent the visit taking place or to terminate the inspection (*paragraph 19*).

⁴ Except in the circumstances described in paragraphs 11 and 26.

(xi) It would avoid potential misunderstandings if a standard routine were laid down for conducting cross-border inspections along the lines recommended in Annex A (**paragraph 20**).

(xii) In those countries where laws do not allow for on-site inspections by supervisors from other jurisdictions, the working group advocates that host supervisors use their best endeavours to have their legislation amended. In the meantime, host supervisors should, within the limits of their laws, be willing to cooperate with any home supervisor that wishes to make an inspection. The working group believes that the host supervisor should have the option to accompany the home supervisor throughout the inspection (**paragraph 21**).

(xiii) It is important that the confidentiality of information obtained during the course of an inspection be maintained. Home supervisors should use their best endeavours to have their legislation modified if it does not offer sufficient protection that information obtained for the purposes of effective consolidated supervision is limited to that use (**paragraph 22**).

(xiv) In the event that a home supervisor, during an on-site inspection in a host country, detects a serious criminal violation of home country law, the home supervisor may be under a strict legal obligation to pass the information immediately to the appropriate law enforcement authorities in its home country. In these circumstances, the home supervisor should inform the host supervisor of the action he intends to take⁵ (**paragraph 26**).

(xv) In order to carry out effective comprehensive consolidated supervision, home supervisors also need information on certain *qualitative* aspects of the business undertaken in other jurisdictions by branches and subsidiaries of banking organisations for which they are the home supervisor. All members of the working group agree that it is essential for effective consolidated supervision that there are no impediments to the passing of such qualitative information to the home supervisor (**paragraphs 14 and 15**).

2. Improving the access of host supervisors to information necessary for effective host supervision

(xvi) In the case of information which is *specific to the local entity*, an early sharing of information may be important in enabling a potential problem to be resolved before it becomes serious. The home supervisor should therefore consult the host supervisor in such cases and the latter should report back on its findings. In particular, it is essential that the home supervisor inform the host supervisor immediately if the former has reason to suspect the integrity of the local operation, the quality of its management or the quality of internal controls being exercised by the parent bank (**paragraph 28**).

⁵ Some members of the working group strongly believe, as is required by their laws, that the home supervisor should be expected to obtain approval from the host country supervisor before informing the home country law enforcement authorities of any suspected violations of home country law.

(xvii) A home supervisor should have on its regular mailing list for relevant material all foreign supervisors which act as hosts to its banks (*paragraph 29*).

(xviii) While the working group agrees that home supervisors should endeavour to keep host supervisors apprised of material adverse changes in the global condition of banking groups, the Group recognises that this will typically be a highly sensitive issue and that decisions on information-sharing necessarily will have to be made on a case-by-case basis (*paragraph 30*).

3. Ensuring that all cross-border banking operations are subject to effective home and host supervision

(xix) The working group has formulated a set of principles of effective consolidated supervision (see Annex B) which could be used by host supervisors as a checklist to assist in determining whether a home supervisor is meeting the Minimum Standards (*paragraph 31*).

(xx) Regional group procedures might be used to support the implementation of the Minimum Standards, as the Offshore Group is now doing (*paragraph 33*).

(xxi) The working group recommends that other regional groups consider the possibility of using a checklist similar to the one used by the Offshore Group (see Annex C) as a means of establishing which of their members might be certified as meeting certain general criteria (*paragraph 34*).

(xxii) The Basle Committee encourages its member countries to assist the Offshore Group or another regional group in the fact-finding verification process, but any decision-making regarding membership of a regional group should be left to that group alone. The Committee has asked its Secretariat to maintain a list of competent persons (for example, retired supervisors) who are available to undertake exercises of this nature (*paragraph 37*).

(xxiii) The supervisor that licenses a so-called shell branch has responsibility for ensuring that there is effective supervision of that shell branch. No banking operation should be permitted without a licence, and no shell office should be licensed without ascertaining that it will be subject to effective supervision. In the event that any host supervisor receives an application to license a new shell branch that will be managed in another jurisdiction, that supervisor should take steps to notify both the home supervisor and the appropriate host supervisor in the other jurisdiction in order to establish that there will be appropriate supervision of the branch before approving the application (*paragraph 39*).

(xxiv) Home supervisors should not authorise their banks to establish or acquire offices in any host jurisdiction without satisfying themselves in advance that such offices will be subject to appropriate supervision (*paragraph 40*).

(xxv) Where the home authority wishes to inspect on-site, they should be permitted to examine the books of the shell branch wherever they are kept. The working group believes that in no case should access to these books be protected by secrecy requirements in the country that licenses the shell branch (*paragraph 40*).

(xxvi) The working group recommends that home or host supervisors be vigilant to ensure that parallel-owned banks (where a bank in one jurisdiction has the same ownership as a bank in another jurisdiction, where one is not a subsidiary of the other) become subject to consolidated supervision, if necessary by enforcing a change in group structure as indicated by the Minimum Standards (*paragraph 41*).

(xxvii) Any home supervisor that licenses a banking entity has a responsibility to monitor its operations on a worldwide basis (*paragraph 42*).

(xxviii) No entity should be allowed to use the word "bank" in its name if it is not conducting banking activities and being supervised as a bank (*paragraph 42*).

(xxix) The working group believes the Basle Committee should advise all host countries to be extremely cautious about approving the establishment of cross-border operations by banks incorporated in under-regulated financial centres, and even more cautious about accepting other financial institutions conducting banking activities from those centres (*paragraph 42*).

III. Improving the access of home supervisors to information necessary for effective consolidated supervision

(a) The nature of information flows

1. The working group recognises that there are several channels through which the home supervisor can receive information. Indeed, effective consolidated supervision relies on a clear hierarchy of information flows from the local banking activity to the home country supervisor. For example, information should be capable of flowing:

- from the subsidiary or branch to the head office or parent bank;
- from the parent bank or the head office to the home supervisor;
- from the subsidiary or branch to the host supervisor;
- from the host supervisor to the home supervisor.

2. In assessing the need for supervisory information, a distinction can usefully be drawn between:

- preliminary information needed to approve an authorisation;
- regular information required to perform ongoing supervision;
- exceptional information requirements in a "watch" or crisis situation.

In all of this, the emphasis is on developing and strengthening collaborative arrangements between the home and host authority over time.

3. As specified in the Minimum Standards, the opportunity arises at the time of authorisation to establish an understanding between home and host supervisors as to what information is required by each party and how it can be provided. In some cases, these understandings take the form of bilateral memoranda of understanding (MOUs) or exchanges of letters which formulate what each party expects from the relationship. The discussions establishing these understandings often help the parties to appreciate more fully the nature of each other's supervisory process, and the comfort that can be taken from it.

4. In seeking to pinpoint information requirements, the working group sees a need for home supervisors to distinguish between what information is essential and what is desirable, and between what is or is not material. In the past, home supervisors' access to supervisory information in host countries has on occasions been impeded by secrecy requirements designed to preserve the traditional confidence of customers that their affairs will be kept confidential.

5. While recognising that there are legitimate reasons for protecting customer privacy, the working group believes that secrecy laws should not impede the ability of supervisors to ensure safety and soundness in the international banking system. It also believes that the recommendations for strengthening the mechanism for exchanging information outlined in this paper will not pose a threat to banks' ability to protect the

confidential relationships they have with customers not engaged in criminal activities. All the recommendations in Part III of this paper are subject to the exceptions described in section (d) where serious criminal activities are involved. Similar exceptions also apply to deliberate evasion of prudential limitations or supervisory rules.

(b) Characteristics of the information required by home supervisors for ongoing supervision

6. The working group notes that home supervisors require two principal types of information: *quantitative* and *qualitative*. The principal emphasis is on credit, market and other financial risks and good organisation and control in the context of ensuring that banks operate prudently and do not take excessive risks that threaten their solvency. In most cases, the risks arise on the assets side of the balance sheet and the predominant concern of home supervisors is therefore with loans and other assets.

7. *Quantitative* information which home supervisors need to have reported to them as a regular routine, on a consolidated basis, include data from the cross-border office needed to calculate, for example, the bank's capital adequacy ratios, large exposures or legal lending limits (including intra-group-exposures) and its funding and deposit concentrations. Home supervisors should be able to expect parent banks to have this information available and to be able to pass it on to them freely (including the number and amount of large deposits). In some jurisdictions, statute requires them to do so. However, home supervisors also need to be able to verify that quantitative information received from banking organisations in respect of subsidiaries and branches in other jurisdictions is accurate and to reassure themselves that there are no supervisory gaps.

8. In some host countries, national legislation poses impediments to the regular collection and verification of supervisory data by the home supervisor. Access to information *on the assets side of the balance sheet* poses fewer problems than the revelation of depositor information. Accordingly, if the home supervisor needs information about non-deposit operations, host supervisors are encouraged to assist in providing the requisite information to home supervisors if this is not provided through other supervisory means. The working group believes it is essential that national legislation that in any way obstructs the passage of non-deposit supervisory information be amended.

9. Where the *liabilities side of the balance sheet* is concerned, home supervisors do not routinely need to know the identity of individual depositors. Their interest in deposits is primarily related to liquidity; what they typically need to know is whether there are any global deposit concentrations and, if so, the amounts involved. Accordingly, aggregate information on deposits above a threshold which is significant in relation to the deposit base, balance sheet or capital base of the institution, along with some information on the geographic source of these deposits, would usually be sufficient. However, a home supervisor

may wish to verify whether or not a given depositor is among the large depositors, in order to monitor deposit concentrations or the funding risk of the deposit being withdrawn or to track all the transactions made by or on behalf of a single client, which may include a group of related companies, in order to monitor the bank's exposure in a problematic situation. In such well-defined circumstances, home supervisors would need access to individual depositors' names and to deposit account information.

10. In order to provide legitimate protection for bank customers, it is important that the information obtained by home supervisors, especially that relating to depositors' or investors' names, is subject to strict confidentiality. In the absence of adequate assurances that the information will be protected, customer confidence will be damaged and host supervisors will understandably be reluctant to allow home supervisors' access. Accordingly, the working group recommends that those host jurisdictions whose legislation allows foreign supervisors to have access to banks' depositor or investor information should subject such access (at the host country's discretion) to the following conditions, which are largely consistent with those laid down in the 1990 Supplement to the Concordat, namely:

- the purpose for which the information is sought should be specific and supervisory in nature;
- information received should be restricted solely to officials engaged in prudential supervision and not be passed to third parties without the host supervisor's prior consent;⁶
- there is assurance that all possible steps will be taken to preserve the confidentiality of information received by a home supervisor in the absence of the explicit consent of the customer;
- there should be a two-way flow of information between the host and home supervisors, though perfect reciprocity should not be demanded;
- before taking consequential action, those receiving information will undertake to consult with those supplying it.

11. In quite a large number of countries, to a greater or lesser extent, supervisors can be compelled by court order, especially in criminal cases, to reveal information to which they have access, including any information which may have been received from a foreign supervisor or acquired during an on-site examination abroad. In a few countries, parliamentary Committees have similar legal or statutory powers to subpoena the supervisory authority to reveal information obtained in confidence. In such circumstances, the supervisory authority as a matter of routine is expected to advise the host supervisor and seek prior consent. If the host supervisor is unable to consent, it is suggested that the home authority should point out to the court or Committee requisitioning the information that insisting on

⁶ Except in the circumstances described in paragraphs 11 and 26.

such revelation could severely damage the future ability of the home supervisor to obtain information necessary for effective supervision, not only in the host country but in other countries too, as well as jeopardising its ability to conduct cross-border inspections. If a host supervisor has good cause to doubt a home supervisor's ability to limit the use of information obtained in confidence solely for supervisory purposes, the host would retain the right not to provide such information.

12. In a few countries, national legislation does not permit a host supervisor, even in well-defined circumstances, to reveal depositor-specific information, whatever assurances the home supervisor is able to give about the confidentiality of the information. The working group recommends that host supervisors whose legislation does not allow a home supervisor to have access to depositor information use their best endeavours to have their legislation reviewed and if necessary amended to provide for a mechanism whereby in exceptional cases a home supervisor, with the consent of the host supervisor, will gain access to depositor information subject to the same conditions as outlined in paragraph 10.

13. Many banks manage investments for customers at the customer's risk. Such funds do not appear on the balance sheet of the bank and do not necessarily involve solvency or liquidity risks, though they may involve legal, reputational and operational risks. It should not normally be necessary for the home supervisor to know the identity of the investors involved, although the home supervisor will wish to check that the bank's systems for managing and recording the investments are adequate. However, in certain exceptional circumstances such as those described in section (d), home supervisors would need access to individual investors' names and to investment account information subject to the safeguards in paragraph 10.

14. In order to carry out effective comprehensive consolidated supervision, home supervisors also need information on certain *qualitative* aspects of the business undertaken in other jurisdictions by branches and subsidiaries of banking organisations for which they are the home supervisor. In particular, they need to be assured that:

- the banking group has an appropriate risk management system covering the whole of its global activities;
- the internal controls and internal audit procedures for controlling the group's overseas operations are of a sufficiently rigorous quality;
- changes in ownership and control of partly owned subsidiaries are monitored;
- the reporting process by which the home supervisor receives information through the channels set out in paragraph 1 is reliable;
- the quality of management is adequate, with a "fit and proper" test for individuals where appropriate;
- the quality of assets and the levels of concentrations are known, and are within appropriate parameters;

- the liquidity of the institution is being monitored and there is no excessive reliance on a single third-party source (or a small number of sources) of funding;
- the statutory laws and supervisory regulations of both the host and home countries are being complied with.

15. The working group agrees that it is essential for effective consolidated supervision that there are no impediments to the passing of such qualitative information to the home supervisor. Host supervisors would therefore be expected to respond freely to any questions posed by a home supervisor and to inform the home supervisor if any area of concern comes to their notice.

(c) Inspections by home country supervisors

16. Under the Minimum Standards, home supervisors are required to exercise comprehensive consolidated supervision of the global activities of their banking organisations. To carry out this responsibility, the home supervisor must be able to make an assessment of all significant aspects of their banks' operations that bear on safety and soundness, wherever those operations are conducted. This can be done through a variety of means, including on-site examinations, access to audit reports and prudential returns, or through the review of other pertinent information.

17. Among the principal areas of concern for home supervisors are internal controls, management competence and other qualitative factors listed in paragraph 14. The lack of appropriate internal controls at an important overseas office can have profound implications for the entire organisation. Consequently, without adequate access to information on the operating and control environment at such offices, home authorities can have no assurance that the overall organisation is being operated in a safe and prudent manner. While the potential for fraud or other improprieties can never be fully eliminated, the risks of wrongdoing can be narrowed by a strong, global operating and control environment.

18. With respect to the overseas operations of the banking groups for which they are responsible, home supervisors should have the ability to implement whatever evaluative techniques are central to their supervisory process. This means that if supervisory inspections are central to their supervisory process, home supervisors should be able to gather information on-site, with appropriate regard to the conditions listed in paragraph 10. In the past this has presented difficulties in some host countries with strict secrecy legislation or sovereignty principles, particularly if the inspection involves access to the names of individual depositors. Balancing the needs of the home supervisor and the interests of the host supervisor, the group has identified the following means, whereby a home supervisor at its discretion might, following consultation with the host supervisor, gather on-site the information necessary for effective comprehensive consolidated supervision:

- independent on-site examination by a home supervisor, accompanied by the host supervisor at the option of the host supervisor;
- on-site examination conducted jointly with the host supervisor, where agreed "sensitive portions" of activity are carried out by the host supervisor and evaluated jointly to protect customer confidentiality;
- on-site examination by a host supervisor under the direction of a home supervisor;
- on-site examination by a host supervisor with a copy of the report of the results of the examination being made available to the home supervisor;
- on-site examination undertaken by an approved external auditor (preferably where the external auditor of the foreign establishment is the same as that of the parent bank) on the basis of detailed instructions from the home supervisor with the concurrence of the host supervisor and with results submitted to both;
- on-site examination undertaken by an internal auditor from the bank's head office whose report is made available to the home and/or host supervisor.

19. In many cases the information required by home supervisors can be obtained on their behalf by the host supervisors, or by the external or internal auditors. Equally, however, there are some things which home supervisors would need to verify for themselves. There are no hard and fast rules as to which information falls into which category; a case by case assessment of the situation is considered appropriate. However, the working group agrees that, subject to appropriate protection for the identity of customers, home supervisors should be able at their discretion, and following consultation with the host supervisor, to carry out on-site inspections in other jurisdictions for the purposes of carrying out effective comprehensive consolidated supervision. This ability should include, with the consent of the host supervisor and within the laws of the host country, the right to look at individual depositors' or investors' names and relevant deposit or investment account information if the home supervisor suspects serious crime as defined in section (d) or an exceptional liquidity situation as in paragraph 9. It is recognised that, if a host supervisor has reason to believe that the visit is for non-supervisory purposes, it should have the right to prevent the visit taking place or to terminate the inspection.

20. Although not all supervisors conduct on-site inspections as part of their regular supervisory arrangements, many do and the working group believes it would avoid potential misunderstandings if a standard routine were to be laid down for cross-border inspections. A proposed routine designed to arrive at a mutually agreeable procedure is set out in Annex A.

21. In certain countries, the laws as they stand at present do not allow for on-site inspections by supervisors from other jurisdictions. Where this is the case, the working group advocates that host supervisors use their best endeavours to have their legislation amended. In the meantime, host supervisors should, within the limits of their laws, be willing to cooperate with any home supervisor that wishes to make an inspection in order to see that the latter

obtains the information required (e.g. by appointing an external auditor to carry out an inspection on the home supervisor's behalf). Alternatively, limited inspections might be permitted subject to the home supervisor being bound by any secrecy provisions applying in the host country. Areas where access restrictions apply (e.g. information on individual customers) would be identified by the host when considering the inspection plan. In all cases the working group believes that the host supervisor should have the option to accompany the home supervisor throughout the inspection, irrespective of whether the home supervisor wishes to delegate responsibility for the inspection (or any part of the process) to the host. In the case of regular contacts, all these procedures could usefully be laid down in a MOU or exchange of letters.

22. It is important that the confidentiality of information obtained during the course of an inspection be maintained. Home supervisors should use their best endeavours to have their legislation modified if it does not offer sufficient protection that information obtained for the purposes of effective consolidated supervision is limited to that use as defined in paragraphs 10 and 11.

(d) Serious criminal activities

23. In most countries, national legislation now provides for bank secrecy laws to be overridden when the law enforcement authorities or the courts have *prima facie* evidence that a serious crime has been committed, such as terrorism, theft, kidnapping, drug-trafficking, extortion, money-laundering or fraud (whether it was committed within a bank, by outsiders against the bank or by the bank itself against third parties). In such cases, there are normally clear legal procedures to enable the courts or law enforcement authorities to obtain information, either domestically or cross-border. For example, an investigation into serious criminal activities may often be initiated by a home country law enforcement authority and proceed with a formal request to the host country judicial authorities for information supported by *prima facie* evidence that an offence has been committed. This procedure will not normally involve the home or host supervisory authority.

24. The working group believes that supervisory authorities in all countries need to ensure that their banks remain vigilant for evidence of such criminal activities and that all supervisors should be required to report such evidence acquired in the course of their supervisory activities to the appropriate authorities. While the working group recognises that banking supervisors are not criminal law enforcement authorities and should normally not be expected to undertake formal investigations into matters that involve apparent violations of criminal law, in some circumstances exceptions will be necessary where such matters are directly related to the performance of their legitimate ongoing supervisory responsibilities.

25. Although home supervisors do not routinely need access to individual depositors' or investors' names, exceptions would be justified when the home supervisor suspects serious

criminal activity or circumvention of prudential requirements which would endanger the financial stability or reputation of the bank. In such cases, the home supervisor has a legitimate reason to have access to the names of individual depositors or investors and to relevant deposit or investment account information. The home supervisor should provide specific information to justify the access, if required to do so by the host supervisor.

26. In the event that a home supervisor, during an on-site inspection in a host country, detects a serious criminal violation of home country law, the home supervisor may be under a strict legal obligation to pass the information immediately to the appropriate law enforcement authorities in its home country. In these circumstances, the home supervisor should inform the host supervisor of the action it intends to take.⁷

(e) Information flows from home supervisor to host supervisor

27. Ensuring adequate information flows from the home to the host authority also raises sensitive issues. There are essentially three types of information the home supervisor may provide which can assist the host authority to exercise effective host country supervision. First, the host authority will obviously be interested in information specific to the local office that it supervises. Second, the host supervisor needs to be informed about the overall framework of supervision in which its banking group operates, i.e. the specific techniques being used by the home country supervisor. Third, it is important that to the extent possible the host supervisor be aware of any significant problem that arises in the head office or in the group as a whole, especially if the local operation is one that is significant in the jurisdiction of the host supervisor.

28. The topic that will be of most immediate concern to the host supervisor will be information which is *specific to the local entity*. Through its relationship with the parent bank, a home country supervisor may obtain information which reveals a problem in an overseas office. Such information may appear relatively minor, such as the incorrect reporting of a position to head office or the belief that certain types of business are being booked in an overseas entity. However, an early sharing of information in such cases may be important in enabling a potential problem to be resolved before it becomes serious. The home supervisor should therefore consult the host supervisor in such cases and the latter should report back on its findings. In particular, it is essential that the home supervisor inform the host supervisor immediately if the former has reason to suspect the integrity of the local operation, the quality of its management or the quality of internal controls being exercised by the parent bank.

29. So far as *more general information* on a banking group is concerned, host supervisor awareness of the regulatory requirements applied by the home supervisor can

⁷ Some members of the working group strongly believe, as is required by their laws, that the home supervisor should be expected to obtain approval from the host country supervisor before informing the home country law enforcement authorities of any suspected violations of home country law.

improve the host supervisor's ability to supervise a local entity and, where appropriate, to assist in reinforcing these regulatory requirements. A home supervisor should also have on its regular mailing list for relevant material all foreign supervisors which act as hosts to its banks.

30. A more sensitive problem relates to the importance of host supervisors being informed of *material adverse changes in the global condition* of banking groups operating in their jurisdictions. While the Working Group agrees that home supervisors should endeavour to keep host supervisors apprised of such changes to the extent appropriate consistent with their responsibilities, the Group recognises that this will typically be a highly sensitive issue for home supervisors (both with respect to substance and timing) and that decisions on information-sharing necessarily will have to be made on a case-by-case basis taking into account all relevant factors.

IV. Ensuring that all cross-border banking operations are subject to effective home and host supervision

(a) Determining the effectiveness of home country supervision

31. The working group has debated at length the difficulties facing host supervisors in determining whether or not foreign banks in their territories are subject to effective comprehensive consolidated supervision as required by the Minimum Standards. While the Basle Committee's Survey of supervisory practices carried out in 1993-94 has proved useful as a starting point, the responses are subjective, less than comprehensive and are not independently verified. The working group has therefore formulated a set of principles of effective consolidated supervision (see Annex B) which could be used by host supervisors as a checklist for determining whether a home supervisor is meeting the Standards. This has not been a simple task because the techniques used to supervise overseas networks differ from country to country and it is suggested that these principles be debated at the June ICBS in Stockholm.

32. Even if the same checklist is used, arriving at a common assessment of countries' supervisory standards presents practical difficulties. There is no enthusiasm for inviting the private sector, e.g. rating agencies or accounting firms to make such assessments, nor is it felt appropriate for the Basle Committee itself to do so. The Offshore members of the working group have suggested that the Basle Secretariat might conduct analyses of supervisory practices without seeking to make judgements about their adequacy; however, the Basle Committee members of the group have serious reservations about any procedure which could be interpreted as an implicit endorsement by the Basle Committee of decisions taken by individual supervisors, and prefer the idea of an independent observer.

33. Another possibility is that regional group procedures might be used to support the implementation of the Minimum Standards, as the Offshore Group is now doing. Each regional group could be encouraged to endorse the principle of effective consolidated supervision and to work towards its implementation, using the checklist in Annex B. The working group believes that this matter, and the implementation of the Minimum Standards in general, could usefully be taken further at the Stockholm ICBS.

(b) Monitoring supervisory standards in host countries

34. Under the terms of the Minimum Standards, there is also an obligation on host supervisors to exercise effective supervision. Prompted by a desire to encourage its members to fulfil appropriate supervisory standards, the Offshore Group now insists on certain conditions being met by a supervisory authority before it can become a member of the Group. Membership has recently been made partly conditional on a fact-finding visit by an independent observer, who assesses the centre's practices on the basis of the factual check-list

reproduced in Annex C. The Offshore Group uses the results to decide whether the standards necessary for full membership of the Group have been met, whether the standards are likely to be met in the next two years (in which case "observer" status may be granted) or whether the application should be rejected outright. The results of the fact-finding exercise are shown to the country being examined so that it would have an opportunity to comment prior to any conclusion being reached. To ensure that the standards are also being met by existing members of the Offshore Group, a process of "rejustification" is envisaged whereby current members would be tested within, say, the next five years. The working group recommends that other regional groups consider the possibility of using a similar checklist as a means of establishing which of their members might be certified as meeting certain general criteria.

35. Conducting such fact-finding visits is not an easy matter for the Offshore Group. Ideally, it would like a home supervisory authority to conduct such visits on its behalf, while leaving the Offshore Group alone to decide whether its criteria have been met or not. It has therefore asked the Basle Committee to assist directly or at least by allowing its Secretariat to act as a "clearing-house" for information collected by its members.

36. The Basle Committee supports the Offshore Group's intention to improve its members' supervisory standards, but does not wish its Secretariat to become directly involved in an exercise of this nature because of the moral hazard involved in appearing to give a "seal of approval". Even for a visit limited to fact-finding, the Committee feels it would inevitably be seen as a key agent in the process. Some of its members question why such visits could not be conducted by an Offshore Group member, by a firm of accountants or by a retired supervisor. The important thing is to ensure consistency of procedure. Others note that the risk of moral hazard could be reduced by using a range of different countries in the verification process. An alternative is that a member of the Offshore Group accompanies a G-10 country representative. In any event, the option should be open to a home supervisor to participate in the fact-finding review if it feels that appropriate.

37. Balancing the pros and cons, the Basle Committee encourages its individual member countries to assist the Offshore Group or another regional group in the fact-finding verification process, but any decision-making regarding membership of a regional group should be left to that group alone. The Committee has also asked its Secretariat to maintain a list of competent persons (for example, retired supervisors) who are available to undertake exercises of this nature.

(c) Other cross-border banking concerns

38. The joint working group has considered a number of issues posed by so-called "*shell branches*", defined in this paper as booking offices licensed in one centre but

effectively managed or controlled from another jurisdiction.⁸ Where the managing or controlling jurisdiction is neither the home or host country, there is concern that in some cases shell branches may not be subject to effective supervision. These branches may not be supervised by the licensing jurisdiction or by the host jurisdiction of the managing/controlling office, or by the home country either.

39. The working group believes that the supervision of any branch is of necessity part of the consolidated supervision exercised by the home supervisor and that this problem should be addressed by strict application of the Minimum Standards. The host supervisor that licenses a shell branch also has responsibility for ensuring that there is effective supervision of that shell branch. No banking operation should be permitted without a licence, and no shell office should be licensed without ascertaining that it will be subject to effective supervision. In the event that any host supervisor receives an application to license a new shell branch that will be managed in another jurisdiction, that supervisor should take steps to notify both the home supervisor and the supervisor in the jurisdiction where the shell branch will be managed. Before approving the shell branch, the host supervisor should be aware of how the home country supervisor, either through its own means or with the assistance of the licensing supervisor and the supervisor in the country where the branch is managed, will ensure the effective supervision of the branch.

40. Indeed, all the supervisors involved in the creation of shell branches i.e. the home supervisor, the host supervisor (licensing authority) and the authority from whose jurisdiction the branch is managed and controlled, should ensure that each of their fellow colleagues is consulted on the structure that is to be established. For example, home supervisors should not authorise their banks to establish or acquire offices in any host jurisdiction without satisfying themselves in advance that such offices will be subject to appropriate supervision. If any authority believes that a supervisory gap exists, they should discuss the matter with the other relevant supervisors with a view to ensuring that the operations of shell branches are brought under effective oversight. Ultimately, it is the responsibility of the home supervisor to assure that any supervisory gap is closed. Where the home authority wishes to inspect on-site, they should be permitted to examine the books of the shell branch wherever they are kept. The working group believes that in no case should access to these books be protected by secrecy requirements in the country that licenses the shell branch. If the home supervisor does not wish to undertake an on-site examination, there should be no constraints on internal and external audits. In either case, if any supervisor, in the course of a regular examination or review of activities booked in a shell branch, happens to notice any unusual activity requiring further investigation, it should notify each of the other supervisors involved.

8 A shell branch may also be managed or controlled directly from a home jurisdiction, but in that case the home supervisor should have access to the information it needs for effective consolidated supervision.

41. The working group is also concerned about *parallel-owned banks*, where a bank set up in one jurisdiction has the same ownership as a bank in another jurisdiction but where the one is not a subsidiary of the other. Such "sister" institutions are not subject to consolidated supervision but at the same time an inter-relationship exists and it could well be that funds are switched from one to the other if a problem arises. The working group recommends that home or host supervisors be vigilant to ensure that operations of this type become subject to consolidated supervision, if necessary by enforcing a change in group structure as indicated by the Minimum Standards.

42. A third problem that deserves attention can arise in the case of *parent institutions incorporated in under-regulated financial centres* which undertake cross-border operations without effective home-country supervision in their country of incorporation. These risks are compounded if the parent is an unsupervised holding company, a trust holding or a bank that does not have a single parent. There is a clear potential for abuse by stand-alone banks incorporated in under-regulated financial centres for unlawful or unauthorised banking activity in other jurisdictions. Any home supervisor that licenses a banking entity has a responsibility to monitor its operations on a worldwide basis and no entity should be allowed to use the word "bank" in its name if it is not conducting banking activities and being supervised as a bank. The working group believes the Basle Committee should advise all host countries to be extremely cautious about approving the establishment of cross-border operations by banks incorporated in under-regulated financial centres, and even more cautious about accepting other financial institutions conducting banking activities from those centres. Similarly, all supervisors, even if they act predominantly as hosts, need to guard against the threat to their good name from rogue overseas activities by banks or non-banks incorporated in their centres.

43. The potential supervisory gaps set out in this section are not exhaustive. There may, for example, be instances of brass-plate subsidiaries or banks owned by non-bank holding companies. These situations should be addressed by strict application of the Minimum Standards.

October 1996

Standard procedures for cross-border inspections

The working group recommends that the following routine should be followed in cases where the home supervisor wishes to undertake a cross-border inspection:

- (i) The home supervisor should contact the host supervisor to let the latter know of an intention to make a visit to a specified branch/subsidiary within the host supervisor's jurisdiction;
- (ii) The home supervisor should be prepared to explain to the host supervisor the purpose of the visit and what aspects of the branch or subsidiary it would wish to explore;
- (iii) The host supervisor should be able to obtain an undertaking from the home supervisor that information obtained in the course of the visit will be used for specific and supervisory purposes and, to the maximum extent possible under applicable laws, will not be passed to third parties without the host supervisor's prior consent. The disclosure of information to third parties would be subject to those conditions outlined in paragraphs 10 and 11 of the main text;
- (iv) The host supervisor should identify to the home supervisor any areas where access to information is normally restricted (e.g. information on individual customers), and the home supervisor should indicate where exceptions are needed;
- (v) The host supervisor should have the option, but not the duty, to accompany the home supervisor during the inspections;
- (vi) Where relevant, the host supervisor should advise the home supervisor of procedures necessary to comply with local/host country legislation and, where necessary or appropriate, assist in ensuring that these procedures are correctly followed to expedite the examination.

Effective consolidated supervision

1. Under the first of the four Minimum Standards, it is required that all international banks be supervised by a home country authority that capably performs consolidated supervision. The purpose of this Annex, and in particular the checklist in paragraphs 6 and 7 below, is to provide examples of some of the principles and factors that could be taken into account in making a judgement about effective consolidated supervision.

2. There can be no single set of criteria to determine whether or not a home supervisor is performing "effective consolidated supervision", since supervisory techniques differ from country to country, due to institutional, historical, legal or other factors. The concepts of consolidated supervision can, however, be defined, namely as a group-wide approach to supervision whereby all the risks run by a banking group are taken into account, wherever they are booked. In other words, it is a process whereby a supervisor can satisfy himself about the totality of a banking group's activities, which may include non-bank companies and financial affiliates, as well as direct branches and subsidiaries.

3. One of the prime reasons why consolidated supervision is critical is the risk of a damaging loss of confidence if an associated enterprise gets into difficulties. This so-called risk of contagion goes well beyond legal liability. Consolidated supervision helps protect the integrity of, and confidence in the group, both supervised and unsupervised elements. More directly, the purpose of consolidated supervision is essentially threefold:

- to support the principle that no banking operation, wherever located, should escape supervision altogether;
- to prevent double-leveraging of capital; and
- to ensure that all the risks incurred by a banking group, no matter where they are booked, are evaluated and controlled on a global basis.

4. It is important to draw a distinction between accounting consolidation, which is a mechanical process, and the concept of consolidated supervision, which is qualitative as well as quantitative. The drawing up of consolidated accounts facilitates consolidated supervision but is not necessarily sufficient. Consolidated accounting may, for example, be inappropriate when the nature of the business or the nature of the risks are markedly different, but that does not mean that the risks should be ignored. Moreover, some risks need to be monitored at local level too. Liquidity concerns, for one, can be considered on a market-by-market (or currency-by-currency) basis, though a group liquidity spectrum would need to include at least the main funding centres. Market risk is another risk that the supervisor may decide should not

necessarily be consolidated: that decision would depend on whether the bank manages its market risks centrally or regionally. Moreover, if a bank is operating in jurisdictions subject to controls on capital flows, offsetting of market (and other) risks through consolidation would not necessarily be prudent.

5. In reaching a decision as to the effectiveness of the consolidated supervision conducted by a home supervisor, the host supervisor will also need to take account of his own supervisory capabilities. If he has limited resources, greater demands will be placed on the home supervisor than if host supervision is strong. The host also has to judge the extent to which its supervision complements that of the home supervisor, or whether there are potential gaps. Accordingly, one host supervisor may decide that a given country is conducting effective consolidated supervision, whereas another host supervisor with different capabilities may decide that it is not. Nonetheless, there are certain common factors on which host supervisors will base their decisions. The checklist below is designed to assist in that decision-making process.

Checklist of principles for effective consolidated supervision

A. Powers to exercise global oversight

6. Does the home country supervisor have adequate powers to enable it to obtain the information needed to exercise consolidated supervision, for example:

- does the bank in question have its own routine for collecting and validating financial information from all its foreign affiliates, as well as for evaluating and controlling its risks on a global basis?
- does the home supervisor receive regular financial information relating both to the whole of the group, and to the material entities in the group (including the head office) individually?
- is the home supervisor able to verify that information (e.g. through inspection, auditors' reports or information received from the host authority)?
- is there access to information on intra-group transactions, not only with downward affiliates but also if appropriate with sister companies or non-bank affiliates?
- does the home supervisor have the power to prohibit corporate structures that deliberately impede consolidated supervision?

B. Exercise of consolidated supervision

7. Which of the following procedures does the home country supervisor have in place to demonstrate its ability to capably perform consolidated supervision:

- adequate control of authorisation, both at the entry stage and on changes of ownership?
- adequate prudential standards for capital, credit concentrations, asset quality (i.e. provisioning or classification requirements), liquidity, market risk, management controls, etc?
- off-site capability, i.e. systems for statistical reporting of risks on a consolidated basis and the ability to verify or to have the reports verified?
- the capability to inspect or examine entities in foreign locations?
- arrangements for a frequent dialogue with the management of the supervised entity?
- a track record of taking effective remedial action when problems arise?

Offshore Group of Banking Supervisors
On-site examination checklist

1. What number, types of banks etc. are licensed in the jurisdiction? Is there any differentiation in the type of banking licence issued, or the conditions imposed and, if so, why? What legislation is in place, when was it last updated, and does it provide for the Basle Committee's minimum standards to be met?
2. What resources are available to the Supervisory Authority, with regard to the background and experience of the supervisory team, and what training programme is in place?
3. What are the requirements which banks/banking groups have to fulfil in order to become authorised in the jurisdiction? What measures are in place to ensure that banks/banking groups are managed and controlled by fit and proper persons?
4. What is the process of authorisation - what objective criteria and what type of background checks are used? What arrangements are in place to ensure the approval of the home supervisor? What regular links are there with other supervisory authorities?
5. What steps are taken to ensure that banks/banking groups are subject to effective consolidated supervision?
6. What financial and prudential information is collected from banks/banking groups in the jurisdiction, and how frequently is the information collected? By what means is the reliability of this information confirmed?
7. Are on-site inspections of banks/banking groups undertaken? If not, what are the alternative arrangements? If so, who carries them out, what is their scope and what is their frequency? Is the home supervisory authority informed of examination findings?
8. What measures are taken to supervise the overseas operations of any banks/banking groups for which the Supervisory Authority is the home supervisor? Are financial conglomerates allowed? If so, what are the arrangements for supervising the operations of non-bank subsidiaries?
9. What limits are applied with regard to the extent to which a bank or banking group can lend to:
 - (a) any one customer (including any arrangements for treating groups of borrowers as one risk);
 - (b) companies or persons connected with the bank/banking group itself; and
 - (c) particular sectors (e.g. real estate)?

10. What rules are in place to monitor:

- (a) solvency;
- (b) asset quality;
- (c) country risk exposure;
- (d) liquidity control systems;
- (e) foreign exchange positions;
- (f) off-balance-sheet activity;
- (g) ownership and organisation structure;
- (h) derivatives activities?

What is the frequency of report on each of the above?

- 11. What arrangements are in place to ensure that banks/banking groups maintain adequate accounting and other records, and adequate systems of control?
- 12. What measures and actions can be taken if the banks/banking groups in the jurisdiction fail to comply with prudential requirements or any other factors that are a cause for concern?
- 13. Are internal auditors from the parent bank or Head Office entitled to inspect the banks in the jurisdiction? Are internal auditors required to meet with/report to the host/home supervisor?
- 14. Are the home supervisory authorities of banks/banking groups entitled to conduct on-site inspections?
- 15. What powers does the supervisory authority have to provide or share information with other supervisory authorities? What kind of information may be provided or shared? What restrictions or constraints are there (if any) on the provision or sharing of information with other supervisory authorities? What statutory or other protection is available for information passed to the supervisory authorities by other authorities?
- 16. Have the Basle Committee's capital convergence proposals been adopted?
- 17. What legislation, rules, etc are in place to control money-laundering activities and to provide for the implementation of the FATF's forty recommendations?
- 18. Are locally incorporated subsidiaries required to publish annual audited accounts? Are all banks subject to external audit and, if so, in what form? What is the criteria for appointing/approving external auditors and do they have to be the same as the auditors of the parent/group?