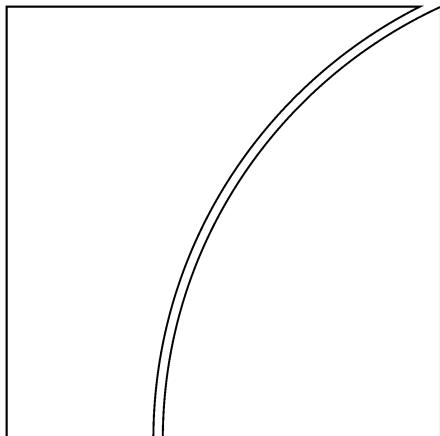


Basel Committee on Banking Supervision



Shell banks and booking offices

January 2003



BANK FOR INTERNATIONAL SETTLEMENTS

Members of the Working Group on Cross-Border Banking

Co-Chairs:

Mr Charles Freeland, Deputy Secretary General, Basel Committee on Banking Supervision

Mr Colin Powell, Chairman, Offshore Group of Banking Supervisors, and Chairman, Jersey Financial Services Commission

Bermuda Monetary Authority	Mr D Munro Sutherland
Cayman Islands Monetary Authority	Mrs Anna McLean
Banque de France/Commission Bancaire	Mr Laurent Ettori
BAFin (German Financial Supervisory Authority)	Mr Peter Kruschel (until March 2002) Mr Thomas Schmitz-Lippert (since March 2002)
Guernsey Financial Services Commission	Mr Philip Marr
Banca d'Italia	Mr Giuseppe Godano
Financial Services Agency, Japan	Mr Hisashi Ono
Commission de Surveillance du Secteur Financier, Luxembourg	Mr Romain Strock
Monetary Authority of Singapore	Mrs Foo-Yap Siew Hong Mr Chua Kim Leng
Swiss Federal Banking Commission	Ms Eva Hüpkes
Financial Services Authority, United Kingdom	Mr Richard Chalmers
Board of Governors of the Federal Reserve System	Mr William Ryback
Federal Reserve Bank of New York	Ms Nancy Bercovici
Office of the Comptroller of the Currency	Mr Jose Tuya Ms Tanya Smith
Secretariat	Mr Andrew Khoo

Shell banks and booking offices¹

1. Shell banks

For the purposes of this paper, shell banks are banks that have no physical presence (i.e. meaningful mind and management)² in the country where they are incorporated and licensed,³ and are not affiliated to any financial services group that is subject to effective consolidated supervision. The mind and management are located in another jurisdiction, often located in the offices of an associated entity or sometimes in a private residence. Typically, a shell bank maintains nothing but a registered agent in its country of incorporation, with the agent having little or no knowledge of the day-to-day operations of the bank, and simply providing an address for legal service in the jurisdiction. Such structures are a particular feature of some offshore centres.

Since a shell bank is not affiliated with a supervised financial services group,⁴ the licensing authority has sole responsibility for its supervision. However, with mind and management located in another jurisdiction, the supervisor is not in a position to supervise the bank (e.g. conduct on-site examination of operations or interface routinely with management) in accordance with the Core Principles. For its part, the supervisory authority in the country from which the bank is run is generally unaware that the bank exists and is being managed from within its jurisdiction. Shell banks conforming to this description frequently have been involved in illegal or suspicious financial activities. The Committee's *Customer Due Diligence for banks* (2001) paper recommended that banks should refuse to enter into or continue a correspondent banking relationship with shell banks located in foreign jurisdictions.⁵

The working group is aware that issues raised by shell banks are being addressed in other national and international fora. A few offshore jurisdictions have recognised the potential problems and have ceased issuing licences to such entities, and have required existing ones either to relocate their principal office to the home country, or to close down altogether.⁶

Shell banks pose serious obstacles to effective supervision, and there are no exceptional arrangements that can be put into place to achieve effective regulatory oversight. To be in line with the Core Principles, supervisory authorities should no longer approve the establishment of shell banks or accept their continued operation.

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 In this paper, the term "physical presence" is defined as "meaningful mind and management" located within the jurisdiction. The existence simply of a local agent or a low-level staff will not constitute physical presence. Management is used here to include administration, viz. books and records.

³ The absence of a physical office to receive customers itself is not inherently bad. For example, there are a number of Internet-only banks that do not have a physical office to receive customers. However, such Internet-only banks can be subjected to supervision to the same extent as banks that conduct their business through physical offices, so long as mind and management are located in the jurisdiction in which they are licensed.

⁴ Subsidiaries or branches of foreign banks are treated in other sections of this paper.

⁵ Paragraph 51, *Customer due diligence for banks* paper

⁶ The USA PATRIOT Act has sought to cut off both direct and indirect access by shell banks to correspondent banking facilities in the US.

Where shell banks already exist, supervisors should set a short deadline (of less than one year) for banks to establish a meaningful mind and management in their jurisdiction, after which time their licences should be withdrawn if they have not complied. The relocation of mind and management should be genuine and not cosmetic, and should permit the supervisor to apply the full range of supervisory tools in accordance with the Core Principles.

2. Booking branches

The term “booking branch” refers to a branch of a foreign bank where the branch has no meaningful mind and management in the jurisdiction in which it is licensed. Often, such branches are nothing more than “brass plates”, with only basic administrative services being supplied by a local agent who may provide such services to a number of banks. The management of the branch may be located in an office in the home jurisdiction of the head office or in an office located in a third jurisdiction, which may or may not be an office subject to supervision. The key distinction between booking branches and shell banks is that the former are part of an existing bank that is regulated by a home country supervisor.

The benefit of establishing booking branches is to allow a bank to conduct certain types of non-resident business in a foreign jurisdiction without the expense of establishing a full foreign branch. These branches have been used to avoid certain domestic restrictions on business in other jurisdictions,⁷ or to provide a contingency arrangement in case there is an increase in the regulatory burden in another jurisdiction that can be mitigated by such a structure. Usually **no local operations are originated** in the branch.

In the case of booking branches managed or controlled directly from a home jurisdiction, the home country supervisor would be in a position to demand that the books and records of branches be available and would have access to the information it needs for effective consolidated supervision.⁸

However, the concern is with booking branches managed or controlled from a third jurisdiction that is neither the home jurisdiction nor the jurisdiction in which they are licensed. Mind and management may be located within a supervised branch, a subsidiary of the parent bank, a sister institution or an unsupervised non-bank institution in the third jurisdiction. In practice, this third jurisdiction will tend most commonly to be the US where the vast majority of booking branches of European and other foreign banks are managed through New York offices. The 1996 paper on the *Supervision of Cross-border Banking* expressed concern that

⁷ Many US banks (and foreign banks with US operations) maintain booking branches, mainly in the Bahamas and Cayman Islands, which lie in the same time zone. It is understood that their reason for doing so is to provide so-called “sweep accounts” to corporate customers. Sweep accounts are used because, under US law, banks are not permitted to pay interest on US-based commercial checking accounts. In order to be able to pay interest to their corporate customers, available customer funds are swept at the end of every business day from the customer’s US checking account to a booking branch account. The funds stay in the booking branch account overnight, and are moved back to a US account the next day. There is no restriction on the ability of US banks to pay interest on such overnight foreign deposits. These overnight deposits could be booked in any foreign branch, but time zone considerations make it problematic to book them in distant locations.

⁸ Sometimes a booking branch is being represented by a local unregulated agent who administers its affairs solely on the basis of instructions from the management of the parent bank. To be able to conduct effective consolidated supervision, the home supervisor must have access to the records kept by the local agent. Such access should be secured in writing from the agent and the parent bank.

such booking branches may escape supervision both by the licensing jurisdiction and by the supervisor in the third jurisdiction.

The home and host supervisors must be satisfied that the principles for effective banking supervision can extend to all the separate parts of such banking structures. One mechanism for minimising any supervisory gaps in the on-going supervision of banking groups with booking branches is a formal understanding between (a) the home supervisor, (b) the host supervisor and (c) the third supervisor in the jurisdiction where mind and management of the booking branch is located. The understanding should spell out the primary responsibility of the home supervisor for consolidated supervision and the responsibilities of each of the other supervisors, so as to ensure that the whole bank is effectively supervised on a consolidated basis. The understanding should also cover sharing of prudential information among the supervisors, so that there will be no impediments to information flows to the head office, and to the home and host supervisors for effective supervision.

The working group proposes the following principles in respect of supervision of booking branches:

- The authorisation process for booking branches should be fully in accordance with the Core Principles. The prior consent of the home country supervisor should be obtained, so that the latter is aware of the existence of the booking branch, has the option to voice any concerns, and is able to confirm that it will include the branch in its ongoing consolidated supervision. If there are conditions attached to the licence of the booking branch, the information should be made known to the home supervisor.
- The licensing authority should require the parent bank to make a formal declaration on how the branch is to be managed, controlled and audited, and confirm that these procedures are in line with the normal oversight procedures for foreign branches. This should include information on where books and records will be kept and the names of all those directly linked to the management. This information should be shared with the home supervisor. The third supervisor should also be made aware that mind and management of the booking branch is to be located in its jurisdiction.
- The head office should accept responsibility for risk management on a global basis, including activities carried through the booking branch, even if risk management for the latter is carried out in the third jurisdiction.
- The jurisdiction that licenses the booking branch should perform its obligations under the Concordat as a host supervisor. It should carry out off-site supervision of the operation through annual interviews with management and the regular (e.g. quarterly) receipt of comprehensive supervisory returns and other relevant information. It should also carry out, either itself or through a delegated agent, on-site examination in the third jurisdiction where mind and management is located, covering, at the very least, the quality of management and controls and local currency liquidity management (if any). For this purpose, there should be no restrictions on the host supervisor in accessing supervisory information in the third jurisdiction.
- The home supervisor should have primary responsibility for the consolidated supervision of the banking group, including the activities of the booking branch. The third supervisor may perform limited supervision of the activities carried out in the booking branch, e.g. check for compliance with policy, controls and processes, and aggregate statistics summarising safety and soundness of the activities.

Booking branches with mind and management exercised by an unregulated entity in a third country cannot be supervised effectively in line with these principles, and should be prohibited.

3. Booking subsidiaries

In a more limited number of cases, banks have also established 'booking subsidiaries'. Such operations are used mainly for private banking or fiduciary relationships. The purpose of incorporating a subsidiary is to segregate the risk of the locally incorporated entity from that of the parent institution. As a general rule, the business of booking subsidiaries is run from the host jurisdiction. Booking subsidiaries are separate legal entities and there is no reason why they should be permitted to be managed from a jurisdiction other than the home or host, as there are increased operational and legal risks. All booking subsidiaries should be embraced by the full home and host responsibilities and relationships strictly in accordance with the Core Principles.

Supervisors should no longer approve the establishment of booking subsidiaries where mind and management is located solely in a third jurisdiction. Where they exist presently, supervisors should set a short deadline (of less than one year) for such banks to relocate mind and management into the parent bank, after which time their licences should be withdrawn if they have not complied.

An arrangement under which mind and management is located in the parent bank should only be permitted where the home supervisor has complete and unrestrained access to all the books and records of the subsidiary, as would be in the case with the parent bank. The arrangement should not be permitted if the bank claims that host country secrecy laws prohibit such access.