

INFORMATION FLOWS BETWEEN BANKING SUPERVISORY AUTHORITIES

(April 1990)

Introduction

In May 1983 the Basle Committee of Banking Supervisors issued a paper entitled "*Principles for the Supervision of Banks' Foreign Establishments*", which set out the views of G-10 banking supervisory authorities as to how responsibilities for the supervision of cross-border banking should be shared between parent and host banking supervisory authorities. That paper, which was a revised version of the Basle Concordat of 1975, subsequently received the broad endorsement of banking supervisors from about seventy-five non-G-10 countries who attended the third International Conference of Banking Supervisors in Rome in September 1984.

In collaboration with the Offshore Group of Banking Supervisors,¹ the Basle Committee has in recent years been exploring practical ways of implementing those aspects of the revised Concordat of 1983 which require flows of cross-border information between supervisory authorities. A joint report by the two Committees was discussed at the fourth International Conference of Banking Supervisors in Amsterdam in October 1986, resulting in the circulation to supervisory authorities worldwide in August 1987 of a paper containing recommendations for practical international collaboration between banking supervisory authorities. The Committee believes the time has now come to recognise the permanent status of the 1987 paper by reviewing and re-issuing its proposals as a supplement to the 1983 Concordat.

The Concordat stresses that effective supervision of a bank's foreign establishments calls for ongoing contact and collaboration between host and parent supervisors. Although there may be extensive initial consultation when a foreign bank first seeks to establish, ongoing contacts may not be close or frequent. From the standpoint of host authorities, a major constraint is frequently the lack of resources, particularly human resources. This applies not only to some offshore centres but also to developed onshore banking countries in their role as host authorities. There are also marked disparities in the methods and depth of different countries' approaches to supervision. As a result, host supervisors may be uncertain what information would be relevant and useful to the needs of the parent authority, and this may inhibit them

¹ See "*The Supervision of Cross-Border Banking*" for a description of the Offshore Group.

from taking the initiative to consult. Parent authorities, for their part, may feel there is little need to approach host authorities for information, particularly when a foreign establishment is small in relation to the parent and its operations are not causing concern.

Although these various considerations may explain the relative lack of information flows, they do not invalidate supervisors' commitment to the principle. Experience has confirmed the importance of information flows to parent authorities in particular to enable consolidated supervision to operate effectively.

The banking supervisory authorities represented on the Basle Committee, recognising the importance of practical collaboration, have developed the attached recommendations as a means of extending and supplementing the principles of the banking supervisors' Concordat of 1983 with some guidance of a more practical nature. They are designed to encourage more regular and structured collaboration between supervisors, with a view to improving the quality and completeness of the supervision of cross-border banking, while not in any way seeking to supplant the discrete responsibilities of host and parent supervisors. As with the Concordat itself, the recommendations are not designed as minimum legal requirements. Rather, they are a statement of best practice which all members have undertaken to work towards implementing, according to the means available to them. The Committee commends the recommendations as being of general validity for all those who are responsible for the supervision of banks which conduct international business and hopes that they will be progressively accepted and implemented by supervisors worldwide. The members of the Offshore Group of Banking Supervisors, as collaborators in the work, subscribe to the recommendations.

Background

The initial opportunity for collaboration between a host and parent supervisor occurs when an individual application by a bank to establish a new foreign presence is first made. The *authorisation* procedure offers an ideal opportunity for host and parent authority to create the basis for collaboration between them in the future. In particular, it can be used as a means of laying the foundation from which an appropriate system of reporting from the foreign establishment to the parent bank can be developed.

More pertinently, however, authorisation is a cornerstone of the Concordat since it is a means of preventing the establishment of banking operations of dubious merit. Despite the fact that host authorities routinely seek to satisfy themselves about the soundness of the applicant and its management capabilities, it still appears to be too easy for banks of doubtful standing or

with little international experience to set up foreign offices in some countries. In some cases, the views of the parent supervisors might be helpful. The first set of recommendations therefore relates to consultations between host and parent supervisors in the context of the authorisation process. It should be noted that these recommendations focus solely on prudential issues and have no relevance to freedom of entry or other competitive issues.

The principal requirement of the *parent supervisor* is to ensure that a routine is laid down for the regular flow of information to the parent bank, and from the parent bank in consolidated form to the parent authority. This calls for a sound system of reporting from foreign establishment to head office or parent bank, for the adequate working of the system to be capable of verification, and for practical solutions to be found for dealing with particular areas of concern.

Parent authorities will generally receive information about the activities of foreign establishments via the head office or the parent bank. In the majority of cases they will be content with this channel, providing they are satisfied that there is an adequate reporting system. However, where parental supervision is carried out on the basis of consolidated reporting, and in the absence of parental inspection, parent supervisors may be ill-equipped to detect major problems in a foreign establishment which may be relatively immaterial in the context of the bank as a whole but which, if allowed to continue, may result in significant losses. The host authority is often in a better position to detect such problems, but it is not always easy for it to judge what would be material information for the parent supervisor. If the problems concern management competence or the bank's reputation in the market, the materiality threshold would be relatively low since this could conceal more fundamental problems. The materiality threshold would also be fairly low in the event of a failure in internal control, such as the misreporting of information to the parent bank. In relation to statistical data of a more general nature, the materiality threshold would be higher, but the parent supervisor would wish to learn about any concerns that are material to the establishment itself, since these may be symptomatic of wider problems. A second set of recommendations deals with the needs of parent authorities.

Mutual trust between supervisory authorities can only be achieved if exchanges of information can flow with confidence in both directions. In the first place, *host supervision* of foreign establishments will be more effective if it is undertaken with an awareness of the extent to which the parent supervisor is able to monitor the foreign establishment and of any prudential constraints placed on the parent bank or the group as a whole. Secondly, host

authorities have a right to be kept informed about matters affecting particular banks with an office in the host territory.

Host authorities may on occasion approach parent authorities for information about particular banks. Provision of factual information by the parent authority - covering, for example, the scope of the activities of a local establishment, its role within the banking group and the application of internal controls - should not present difficulties and would help the local supervisor to direct his work with greater understanding. Specific supervisory requirements by the parent supervisor, such as a decision to require a banking group to sustain a capital ratio in excess of the 8% standard set out in the Basle Accord, might also be relevant for effective supervision by the host authority.

Host authorities would also wish to be notified by parent supervisors of significant matters affecting a parent bank or head office. An example would be an impending change of ownership. While a parent supervisor would be naturally reluctant to divulge information which may be highly market-sensitive, there are occasions on which a host supervisor has information about the new owner which could damage confidence in the bank if revealed at a later date. Equally sensitive considerations arise in the case of banks facing serious problems. It is recognised that parent authorities cannot always be expected to communicate potentially damaging information about the difficulties of a parent bank, disclosure of which would hinder the restoration of confidence. Nonetheless, there may be situations where close liaison between parent and host authorities would be mutually advantageous, for example, in monitoring the liquidity of establishments located in major funding centres. A third set of recommendations considers the information needs of host authorities.

A possible obstacle to the transmission of prudential information of the nature described above is the existence of national *secrecy laws* designed to protect the legitimate interests of bank customers. This does not prevent exchanges of information between national authorities about important but generalised aspects of prudential supervision, such as management competence and internal control systems. There is also in general no impediment to the passage of statistical information from foreign *branches* to the head office and thence to the parent authority. However, the law in some host countries may not always allow the transmission of specific named customer information from foreign *subsidiaries* to the parent bank. Although those difficulties relate primarily to deposit balances - which are generally of relatively minor interest to supervisors - there are a few banking centres where secrecy requirements also extend to asset balances. The same obstacles prevent a host supervisor from passing specific information of this kind to a parent supervisor.

A prerequisite for effective collaboration between supervisory authorities is the freedom to exchange prudential information, subject to certain conditions designed to protect both the provider and receiver of the information. A fourth set of recommendations therefore concerns the removal of secrecy constraints to enable national supervisors to exchange information with their fellow supervisors abroad on certain strict conditions in line with the legal modifications made in most of the major banking centres over recent years.

Irrespective of the extent to which individual supervisory authorities make use of external auditors in the prudential process, the supervisory community as a whole can gain reassurance from sound international auditing standards. Indeed, since foreign establishments are often, in practice, beyond the reach of parent supervisors' inspection systems and frequently are not subject to a formal inspection system in the host country, the *external audit* may be the only independent check on a bank. The supervisory authorities represented on the Basle Committee attach considerable importance to thorough and reliable standards of external audit.

At present, not all foreign establishments of banks are subject to external audit and, even where they are, the quality of the audit may not always be of sufficient thoroughness. This places sole and sometimes excessive reliance on the internal audit process. The final set of recommendations concerns the role of external audit.

SUPPLEMENT TO THE CONCORDAT

The ensuring of adequate information flows between banking supervisory authorities

The Concordat of 1983 stresses that effective supervision of banks' foreign establishments calls for ongoing contact and collaboration between host and parent supervisors. The recommendations included in this document are designed to supplement the principles of the Concordat by encouraging more regular and structured collaboration between supervisors, with a view to improving the quality and completeness of the supervision of cross-border banking, while not in any way seeking to supplant the discrete responsibilities of host and parent supervisors. As with the Concordat itself, the recommendations are not designed as minimum legal requirements. Rather they are statements of best practice which all members have undertaken to work towards implementing, according to the means available to them.

A. Authorisation

The initial opportunity for collaboration between a host and parent supervisor occurs when an individual application by a bank to establish a new foreign presence is first made. The

authorisation procedure offers an ideal opportunity for host and parent authority to create the basis for collaboration between them in the future. In particular, it can be used as a means of laying the foundation from which an appropriate system of reporting from the foreign establishment to the parent bank can be developed. Authorisation is a cornerstone of the Concordat.

Recommendations

- (i) Host authorities should as a matter of routine check that the parent authority has no objection before granting a banking licence.
- (ii) Where a host authority is unable to obtain a positive response from the parent authority, it should consider either refusing the application, increasing the intensity of supervision or imposing conditions on the grant of authorisation. In the latter case, it is recommended that the conditions (and any subsequent changes in the conditions) should be communicated to the parent authority.
- (iii) Host authorities should exercise particular caution in approving applications for banking licences from foreign entities which are not subject to prudential supervision in the parent country or joint ventures for which there is no clear parental responsibility. In such circumstances, any authorisation should be contingent on the host authority's capacity to exercise a parental role.
- (iv) If the host authority follows the procedures outlined in sub-section (i), a parent authority which disapproves of its bank's plans to establish abroad can recommend the host authority to refuse a licence. Parent authorities nonetheless should ensure that they have taken adequate steps to prevent their banks establishing in unsuitable locations or making inappropriate acquisitions. Where the parent supervisor imposes conditions on a foreign establishment, such conditions should be communicated to the host authority.

B. Information needs of parent authorities

The principal requirement of the parent supervisor is to ensure that a routine is laid down for the regular flow of information to the parent bank, and from the parent bank in consolidated form to the parent authority. This calls for a sound system of reporting from foreign establishment to head office or parent bank, for the adequate working of the system to be capable of verification, and for practical solutions to be found for dealing with particular areas of concern.

Recommendations

- (i) Host and parent authorities should seek to satisfy themselves that banks' internal controls should include comprehensive and regular reporting between a bank's foreign establishments and its head office.
- (ii) If a host authority identifies, or has reason to suspect, problems of a material nature in a foreign establishment, it should take the initiative to inform the parent supervisor. The level of materiality will vary according to the nature of the problem. Parent supervisors may wish to inform host authorities as to the precise levels of materiality which would trigger their concern, for the level of materiality is principally a matter for the parent authority's judgement. However, the host authority is often in the best position to detect problems and therefore should be ready to act on its own initiative.
- (iii) Parent authorities may wish to seek an independent check on data reported by an individual foreign establishment. Where inspection by parent supervisors is permitted, host authorities should welcome such inspections. Where inspection by parent supervisors is not at present possible (or where the parent authority does not use the inspection process), the parent authority can consult the host authority with a view to the host authority checking or commenting on designated features of the bank's activities, either directly or through the use of the external auditor. Whichever method is chosen, it is important that the results obtained should be available to both host and parent supervisor.
- (iv) If serious problems arise in a foreign establishment, the host authority should consult with the head office or parent bank and also with the parent authority in order to seek possible remedies. If the host authority decides to withdraw banking authorisation from a foreign establishment or take similar action, the parent authority should, where possible, be given prior warning.

C. Information needs of host authorities

Mutual trust between supervisory authorities can only be achieved if exchanges of information can flow with confidence in both directions. Host supervision of foreign establishments will be more effective, firstly, if it is undertaken with an awareness of the extent to which the parent supervisor is able to monitor the foreign establishment and of any prudential constraints placed on the parent bank or the group as a whole; and, secondly, if host authorities are kept informed about matters affecting particular banks with an office in the host territory.

Recommendations

- (i) Parent authorities should inform host authorities of changes in supervisory measures which have a significant bearing on the operations of their banks' foreign establishments. Parent authorities should respond positively to approaches from host authorities for factual information covering, for example, the scope of the activities of a local establishment, its role within the banking group and the application of internal controls and for information relevant for effective supervision by host authorities.
- (ii) Where a parent authority has doubts about the standard of host supervision in a particular country and, as a consequence, is envisaging action which will affect foreign establishments in the territory concerned, advance consultation is recommended so that the host authority may have an opportunity to correct any inadequacies.
- (iii) In the case of particular banks, parent authorities should be ready to take host authorities into their confidence. Even in sensitive cases such as impending changes of ownership or when a bank faces problems, liaison between parent and host authorities may be mutually advantageous.
- (iv) If a parent authority is intending to take action to protect the interests of depositors, such action should be coordinated to the extent possible with the host supervisors of the bank's foreign establishments.

D. Removal of secrecy constraints

A prerequisite for effective collaboration between supervisory authorities is the freedom to exchange prudential information, subject to certain conditions designed to protect both the provider and receiver of the information. A possible obstacle to the transmission of prudential information is the existence of national secrecy laws designed to protect the legitimate interests of bank customers.

Recommendations

Countries whose secrecy requirements continue to constrain or prevent the passage of information to banking supervisors abroad are urged to review and amend their requirements subject to the following conditions:

- (i) Information received should only be used for purposes related to the prudential supervision of financial institutions. It should not be released to other officials in the recipient's country not involved in prudential supervision.

- (ii) The arrangements for transmitting information should be reciprocal in the sense that a two-way flow should be possible, but strict reciprocity in respect of the detailed characteristics of the information should not be demanded.
- (iii) The confidentiality of information transmitted should be legally protected, except in the event of criminal² prosecution. All banking supervisors should, of course, be subject to professional secrecy constraints in respect of information obtained in the course of their activities.
- (iv) The recipient should undertake, where possible, to consult with the supervisor providing the information if he proposes to take action on the evidence of the information received.

E. External audit

Supervisors can gain reassurance from sound international auditing standards. At present, not all foreign establishments are subject to external audit and, even where they are, the quality of the audit may not be of sufficient thoroughness. Where foreign establishments are, in practice, beyond the reach of parent supervisors' inspection systems and where they are not subject to a formal inspection system in the host country, the external audit may be the only independent check on a bank.

Recommendations

- (i) The existence of adequate provision for external audit should be a normal condition of authorisation for new establishments. It would be advantageous for the audit firm to be the one that audits the parent bank, provided the firm in question has the appropriate capacity and experience in the local centre. Where a foreign affiliate is audited by a different firm, the external auditor of the parent bank should normally have access to the audit papers of the affiliate.
- (ii) Supervisors have an interest in the quality and thoroughness of audits; in the case of audits that are inadequately conducted, supervisors should address criticism to the local representative body of auditors and should be empowered, where necessary, to have the auditor replaced. As a means of raising auditing standards for international banks,

² Supervisors may also be subpoenaed to give evidence in civil cases. Although in some countries they may be open to contempt of court if they refuse, they can make clear that, if the court insists, the information flow would dry up and their own ability to supervise effectively in future would be impaired.

internationally qualified auditors with experience of banking audit in the country concerned should be appointed. Where any doubt arises, host and parent authorities should consult.

(iii) External auditors may also be asked to verify the accuracy of reporting returns or compliance with any special conditions. It is recommended that all supervisory authorities should have the ability to communicate with banks' external auditors and vice versa. Any emphasis on the role of external auditors should, however, in no way be such as to downgrade the need for sound internal controls, including provision for effective internal audit.