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SUPERVISION OF INTERNATIONAL BANKING POST-BCCI

Hal S. Scott†

INTRODUCTION

Let me begin by expressing my gratitude to Georgia State University and to the College of Law, and particularly Acting Dean Blasi, for inviting me to be the tenth Henry J. Miller Distinguished Lecturer. I would also like to thank the Loridans Foundation for sponsoring this lecture series. It is an honor and pleasure to be with you today. The topic of my lecture is the supervision of international banking post-BCCI. My address builds on a recent study I coauthored with Sydney Key, a Federal Reserve Board economist, entitled *International Trade in Banking Services: A Conceptual Framework*, published last summer by the Group of Thirty.¹ The focus of my remarks will be on the problems of host countries in supervising foreign banks, with particular emphasis on the United States as a host country. I will not examine the equally important question of how host countries can and should deal with competition from foreign banks.

There are three key policy objectives of host countries which affect their supervision of foreign banks: (1) maintaining safety and soundness, (2) avoiding systemic risk, and (3) protecting depositors. I will examine how each of these policies applies

† Nomura Professor of International Financial Systems, Harvard Law School. This lecture was given on November 6, 1991. It has been substantially revised for publication.

1. SYDNEY J. KEY & HAL S. SCOTT, *INTERNATIONAL TRADE IN BANKING SERVICES: A CONCEPTUAL FRAMEWORK* (Group of Thirty Occasional Papers No. 35, 1991).

when a foreign bank operates in a host country through branches or subsidiaries. Problems of supervision differ depending on which of these two forms one is considering. Of course, branches and subsidiaries are not the only forms in which banks operate abroad. They can also operate purely cross-border without a corporate presence in a host country, as when a bank in London solicits U.S. residents to place funds with the London bank. Banks may also operate abroad through agencies and representative offices. But branches and subsidiaries are the most important forms of operation, and I will concentrate on them.

I. SAFETY AND SOUNDNESS

Host countries generally have less concern with maintaining the safety and soundness of foreign banks operating through subsidiaries than they do in the case of branches.

A. *Subsidiaries*

When a foreign bank operates through a subsidiary, the subsidiary is fully subject to the safety and soundness regime of the host country. The host country can ensure the safety and soundness of the foreign subsidiary through the same techniques it applies to domestic banks, such as capital requirements, examinations or audits, and loan limits. The host country will not necessarily be concerned with the safety and soundness of the foreign parent of the host-country subsidiary. The bankruptcy of the parent may result in a transfer of the ownership of the subsidiary, but it will not necessarily affect the safety and soundness of the subsidiary. The subsidiary can continue to operate even though its parent is bankrupt. We have seen this in the Bank of Credit and Commerce International (BCCI) case where alleged subsidiary U.S. banks, like the First American banks, have continued to operate even though the BCCI bank owners are in insolvency proceedings.

But some countries, most notably the United States, are concerned with the safety and soundness of the foreign parents of host-country subsidiaries. This concern is based on the source of strength doctrine. Under this doctrine, the host country looks to the foreign parent to supply capital to the subsidiary if the subsidiary becomes weak. The basic idea is that the strength of the parent determines whether it will be able to save its

subsidiary from difficulty by injecting additional capital. In addition, the host country may be concerned that a weak foreign parent may try to loot a local subsidiary through nonmarket value affiliate transactions, for example, purchasing its assets at below market prices.²

The safety and soundness of the foreign parent is not, however, within the regulatory control of the host country. For example, the safety and soundness of a U.K. banking parent of a U.S. bank is largely determined by the United Kingdom, not the United States. The United Kingdom determines the capital requirements, auditing and examination standards, and loan limits of its banks. And if one of its banks gets into trouble, the United Kingdom determines whether and how to rescue it. However, if the foreign parent is not a bank, it may be entirely unregulated by the home country.

A key element with respect to safety and soundness is capital. Here we have some international standards. The Group of Ten (G-10) central banks that belong to the Bank for International Settlements in Basle, Switzerland (actually central banks from twelve countries),³ reached an Accord on capital standards in 1988. Other non-G-10 countries subsequently declared their adherence to the Basle Accord. If the home country of a foreign bank parent subscribes to the Accord, the host country may have some comfort that the parent is safe and sound, but would not have complete assurance.

The Basle Accord deals only with credit risk, making capital adequacy turn on the riskiness of a bank's assets and off balance sheet liabilities; it does not deal with interest rate risk. The standards must be enforced by the home country, and the G-10 and additional subscribers differ in their enforcement capabilities. If assets are worth substantially less than a bank carries them on its books, the bank may have adequate book capital, as prescribed by Basle, but not real capital, which is simply the difference between the real value of assets and liabilities. It is up to the home country to make sure that assets

2. The Hong Kong subsidiary of BCCI was closed on July 8, 1991, shortly after its parent holding company, BCCI Holdings (Luxembourg) SA, was declared insolvent. The Hong Kong subsidiary's insolvency had been largely caused by the discovery of over \$268 million in unrecorded liabilities, some of which were due to other failed BCCI entities. A subsidiary may also be imperiled by loans made to failed affiliates.

3. Specifically, Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

are correctly valued and that loan loss reserves are sufficient. Finally, the Accord only applies to banks, and thus generally cannot protect host countries whose banks are owned by nonbank holding companies rather than banks.

In addition, the Accord is not a treaty—it is a gentleman's agreement among central bankers. While central bankers take their agreements seriously, political officials may override them. For example, President Bush recently indicated that the United States would adopt a more liberal definition of capital than had previously been used by the Federal Reserve Board in implementing the Basle Accord—counting noncumulative perpetual preferred stock as so-called Tier I capital on an unlimited basis for bank holding companies—to alleviate the credit crunch. The Federal Reserve subsequently implemented this proposal. The idea is that, assuming adequate loan demand, more liberal capital requirements will increase bank lending. In fact, the Basle Accord does not regulate bank holding company capital; it only applies to banks. Thus, the Administration proposal did not actually derogate from the Accord. But the possibility existed that it might have proposed a more liberal definition of capital for banks than the Accord itself permitted.

It bears repeating that host countries do receive some assurance that bank parents of local subsidiaries are adequately capitalized, and therefore are more likely to be safe and sound, when the home countries of the parents subscribe to the Basle Accord. Host countries mainly become concerned with bank parents' safety and soundness when the subsidiaries of these foreign banks get in trouble, that is, when it is necessary to use these foreign bank parents as a source of strength for their subsidiaries.

B. Branches

When a foreign bank operates abroad through a branch, the host country is more at the mercy of the home country. The branch is but an office of a bank located in another country. If the foreign bank fails, so do its branches abroad. The viability of the branches is largely determined by the efficacy of supervision by the bank's home country. Host countries again may get some comfort from the fact that the bank's home country subscribes to the Basle Accord, but here the weaknesses of the Basle approach are more serious since the failure of the foreign bank leads

directly to the failure of its branches, rather than just depriving the host country of a source of strength as is the case with subsidiaries.

It may be tempting to conclude that host countries would be better off if they forced foreign banks to operate in their countries through subsidiaries rather than branches, but this would be incorrect, principally for two reasons. First, many host countries would prefer that local deposits be backed by the entire capital of the bank, which is the case with branch deposits, rather than the capital of the local subsidiary, the case with subsidiary deposits. Although the host country may have less control over the capital adequacy of the entire bank than it does over the subsidiary, the amount of capital is likely to be much larger. Also, many host countries, particularly smaller or less developed ones, may prefer to rely on home-country supervision rather than their own. Second, and quite important, branches of foreign banks are more competitive than their subsidiaries in host-country markets. This is largely because the loan capacity of the branch in the host country is a function of the bank's worldwide capital; that capacity would be much less if it were a function of the capital of a host-country subsidiary. The competitive superiority of branches is reflected in the fact that of the \$800 billion total of foreign bank assets in the United States, \$626 billion is in branches and agencies of foreign banks—only \$174 billion is in subsidiaries.

Nonetheless, the United States is moving in the direction of limiting the ability of foreign banks to operate through branches. Section 214 of the Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991⁴ requires that in the future foreign banks that "accept or maintain" deposits of less than \$100,000 (so-called retail deposits) do so through insured subsidiaries rather than through insured branches. Before the passage of this legislation, foreign banks could take insured deposits through either form, though, in fact, the vast majority of insured deposits were taken through subsidiaries. This new legislation permits the United States to have more supervisory control over foreign banks whose deposits it is insuring. The legislation continues to permit branches of foreign banks to take deposits of \$100,000 or

4. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2236 (1991).

more,⁵ but section 215 of the Act authorizes a study by the Secretary of the Treasury and the Federal Reserve Board, in consultation with the Office of the Comptroller of the Currency (OCC), FDIC, and the Attorney General, of whether foreign banks should generally be required to conduct their banking operations in the United States through subsidiaries rather than branches.

C. *Determination of the "Home" Country*

Let me turn to another key supervisory issue: How to determine the "home" country of a foreign bank. Since the adequacy of home-country supervision may be an issue for a host country with respect to subsidiaries, and is clearly an issue in the case of branches, identifying the home country for this purpose is essential. This can be done without much difficulty if two conditions hold: (1) there is one foreign bank parent located in one foreign country, and (2) the principal operations of the bank are carried on in that same country. For example, Deutsche Bank, the ultimate parent of all Deutsche Bank foreign subsidiaries, is located in Germany, and the principal operations of Deutsche Bank, as measured by total assets, are in Germany as well. Neither of these conditions was met, however, in the case of BCCI, with somewhat disastrous results.

BCCI was organized as follows. BCCI Holdings, a Luxembourg holding company, was at the top of the corporate pyramid. This entity, in turn, owned two principal banks, BCCI S.A., incorporated in Luxembourg, and BCCI Overseas, incorporated in the Cayman Islands. These banks had subsidiaries and branches in various countries; for example, the Luxembourg bank had over twenty branches in the United Kingdom and a subsidiary in Canada. There were two foreign bank parents rather than one, and neither bank's principal operations were in the country of incorporation, namely Luxembourg or the Cayman Islands.⁶

5. The legislation's language actually goes further than may have been intended. In fact, it appears to make it illegal for an uninsured branch to *maintain* deposits of less than \$100,000. Obviously, initial deposits of over \$100,000 can fall below this amount over time as a result of net withdrawals. This issue is currently being addressed by the regulatory agencies and the Congress.

6. BCCI Holdings also owned other bank subsidiaries in countries such as Australia and Hong Kong, but these banks apparently had no offices abroad.

Why did this cause problems? The fact that there were two foreign bank parents meant that two countries rather than one were responsible for the safety and soundness of the banking organization as a whole; thus, there was no overall consolidated supervision of the banking organization. In principle, this problem might have been cured if Luxembourg had authority to regulate the entire operations of the bank holding company, BCCI Holdings, but this was not the case. The problem might also have been cured if there had been an international agreement that there could only be one ultimate bank parent, that is, that one of the banks had to become a subsidiary of the other, but this was also not the case.

Where two home countries are responsible, neither country is in the position to determine the safety and soundness of the entire operation, and matters can easily fall between the cracks. Where multiple regulators are responsible for the safety and soundness of a bank, no one is really accountable. Further, since the principal operations of the banking organization were in neither country, the supervisors in these countries had a limited ability to make judgments about the safety and soundness of their two banks. Perhaps in such cases the home country should be the country of principal operations, which would probably be the United Kingdom in the case of BCCI. The problem was further compounded by the fact that supervision in the Caymans, and to a lesser extent in Luxembourg, was rather weak.

D. The Need for International Standards

Certain international measures are needed to further protect host countries against unsafe or unsound foreign banks. First, the Basle Accord needs to be expanded to include risks other than credit risk. Other important matters bearing on safety and soundness, such as methods of examination and audit, may also require the formulation of international standards. In addition, there must be a procedure for determining the home country of an international banking organization, with consideration given to proscribing hydra-headed organizations like BCCI and to the selection of a "home country" where principal operations are not carried on in the country of incorporation. All of these measures need to be put on a sounder legal footing than a gentlemen's agreement among central bankers, and means need to be devised

to assure that the standards are followed and enforced by states that are party to the agreements.

E. Unilateral Measures in the United States

In the absence of such international agreements, host countries will have to protect themselves unilaterally by insisting that foreign banks operating in their countries conform to certain host-country standards. Along these lines, sections 201 to 209 of the FDIC Improvement Act of 1991 strengthened the powers of the Federal Reserve Board to supervise, regulate, and examine foreign bank operations in the United States. The most important provisions of this legislation are as follows.

First, Federal Reserve Board approval will be required for the establishment of all branches and agencies of foreign banks in the United States. In the past, as part of our dual banking system, federal approval was only required for federal branches; states approved state-licensed branches. Second, any foreign bank seeking to operate in the United States, whether by branch or by subsidiary, must demonstrate that it is subject to comprehensive and consolidated supervision in its home country. In addition, the Federal Reserve Board may consider whether the financial and managerial resources of the foreign bank are satisfactory, whether the foreign bank's home-country regulators have approved the establishment of a United States office, whether the foreign bank has provided adequate assurance of the availability of information to United States regulators to determine and enforce compliance with United States laws, and whether the foreign bank is in compliance with United States laws. Third, the Federal Reserve Board will be given the power to terminate the activities of a foreign bank's branch, agency, or lending company if the foreign bank is not subject to comprehensive and consolidated supervision, has committed a violation of law, is engaged in an unsafe or unsound practice, or if the continued operation of the office would not be consistent with the public interest or statutory purposes.⁷ Fourth, federal

7. A termination of host-country operations would risk triggering repayment claims by unpaid depositors against the home-country head office of the affected bank. See *Wells Fargo Asia Ltd. v. Citibank*, 936 F.2d 723 (2d Cir. 1991), *on remand from* 110 S. Ct. 2034 (1990), and *petition for cert. filed*, 60 U.S.L.W. 3360 (U.S. Oct. 24, 1991) (No. 91-689).

regulators are given more power to obtain information about the operations of foreign banks here and abroad.

These unilateral measures may be justified given the risks to host countries signalled by the BCCI affair. Unilateral measures in the name of safety and soundness, however, can easily be used as a subterfuge for protectionism; they have been used by countries to protect domestic banks from increased competition. Various entry limits imposed by foreign countries have been, in fact, a major concern of the United States. One advantage of formulating international standards for safety and soundness would be to limit the protectionist potential that arises from unilateral measures.

II. SYSTEMIC RISK

The host country needs to protect itself against systemic risk, the risk that the failure of one bank will lead to the failure of other banks. The concern with systemic risk only arises, of course, when one bank fails. But this can occur even with the best supervisory control system. A chain reaction of bank failures can occur through three principal means.

A. *The Chain Reaction Problem*

First, a chain reaction can result from the linkage of interbank deposits. This was a major concern when Continental Illinois Bank almost failed in the mid-1980s. Continental held sizable deposits of other banks; in many cases the amount of the deposits substantially exceeded the capital of the depositor banks. These banks generally held such sizable deposits because they cleared payments, for example, checks or wire transfers, through Continental. If Continental had failed, those banks would have failed as well. Section 308 of the FDIC Improvement Act of 1991 gives the Federal Reserve Board new powers to deal with this problem. It permits the Board to limit the credit extended by an insured depository institution to another depository institution. This may be feasible with respect to placements by one bank with another since the amount of credit extended is fixed for a given term. It will be more difficult with respect to interbank clearing accounts where the amount of credit extended is a function of payments traffic. For example, Bank A may be credited by its correspondent Bank B for an incoming wire transfer of \$10 million. Bank A is thus a creditor of Bank B for

this amount. If Bank *B* were to fail, Bank *A* is seriously exposed. It will be quite difficult, without serious changes in the payment system (for example, forcing banks to make and receive all payments through Federal Reserve rather than correspondent accounts), to limit these types of exposures.

Second, a chain reaction of bank failures can occur through payment system linkage. If one bank fails to settle its position in a net settlement system for large value payments, for example, the Clearing House Interbank Payments System (CHIPS) in the United States, other banks which do not get paid may in turn fail. This risk has been substantially limited by CHIPS credit limits, loss-sharing, and collateral requirements, but could still materialize if two large banks, at the maximum of their permissible net debit positions, were to fail.

Finally, a chain reaction of bank failures can occur through imitative runs. When one bank fails, depositors in other banks, particularly those that are uninsured, may assume that their banks may also fail and so withdraw their funds, exposing these banks to a liquidity crisis and ultimately to failure.

B. Subsidiaries

When a foreign bank operates in a host country through a subsidiary, the host country can protect itself against systemic risk by subjecting the subsidiary to the same rules as other domestic banks. For example, the host country can control the level of deposits the subsidiary takes from other banks or limit the positions it incurs in net settlement payment systems in the same way as it does for domestic banks. Imitative runs could be a major concern to a host country since the failure of any domestic bank, even one that is foreign owned, could cause imitative runs on other domestic banks. For example, there were reportedly imitative runs on other foreign banks in Hong Kong when BCCI's subsidiary in that country was closed. It is much less likely that the failure of the foreign parent will cause a run on host-country banks. While there is some evidence that there was a deposit loss at First American after the failure of BCCI, it is unclear whether this was caused by the BCCI failure or a growing problem with bad loans. In any event, there were no runs on First American or other non-BCCI domestic banks.

If the failure of a foreign-owned bank would likely cause a chain reaction of bank failures, the host country could use its

lender-of-last-resort power to keep the bank afloat. The host-country central bank would be lending to a domestic bank in its own currency—the fact of foreign ownership should not be a major obstacle to central bank support.

C. Branches

When a foreign bank operates in a host country through a branch, it is more difficult for the host country to deal with the systemic risk problem, particularly as it may manifest itself in the payment system. Branches of foreign banks may be less able than domestic banks to fund settlement obligations quickly in host-country money markets, and their home-country markets could be closed. On the other hand, linkage of interbank deposits should not be a significant problem since domestic banks generally will not clear local currency payments through branches of foreign banks. In addition, imitative runs on domestic banks are less likely to be caused by the failure of a foreign bank; depositors in domestic banks are unlikely to believe their own banks are in trouble just because a foreign bank has failed. The major concern is the payment system.

Unlike the case of the failure of a foreign-owned subsidiary, the failure of the foreign bank itself, along with its host-country branch offices, raises significant lender-of-last-resort issues for the United States. The foreign bank may have to be kept afloat by its own central bank through loans in the home-country currency. But the United States will have no assurance that the home-country central bank will do so. While the Federal Reserve could, in principle, itself extend credit in dollars to the foreign bank, it will be reluctant to do so. Such lending might expose it, and ultimately U.S. taxpayers, to losses. This will be hard to justify when support could have come instead from the home-country central bank.⁸

8. Section 142 of the FDIC Improvement Act of 1991 (effective in 1993) has generally made Federal Reserve (Fed) lending to failing banks—"critically undercapitalized depository institutions"—more expensive for the Fed. If the Fed makes new loans to institutions five days after they become critically undercapitalized, the Fed may incur losses on the increased advances. Its loss will be the lesser of interest received on the increased advances or the loss it would have had on the increased advances if they had been unsecured (Fed loans are almost always fully secured in practice). The prospect of such losses may generally restrain Fed lending to failing banks, and particularly to failing foreign banks.

The host country is likely to take measures to avoid becoming a lender-of-last-resort to a foreign bank. First, it may limit the participation of branches of foreign banks in host-country payment systems. The Banque de France, for example, does not allow foreign banks to participate directly in Sagittaire, its net settlement system for clearing international funds transfers. And it is perhaps not an accident that no foreign banks are settlement participants in the CHIPS system in the United States. Second, the host country may specially limit the settlement positions of branches of foreign banks in their payment systems or require that these positions be fully collateralized.

D. The Herstatt Experience

The United States has had some experience, albeit limited, with the effect of a foreign bank failure on its payment system. On June 26, 1974, at 10:30 a.m. New York time, German banking authorities closed Bankhaus I.D. Herstatt, K.G.a.A (Herstatt), declaring it insolvent, with the effect of suspending all its payments. While Herstatt had no foreign branches in the United States, it held a clearing account with Chase Manhattan Bank (Chase), and used Chase to make and receive payments on its behalf through CHIPS, which at that time had a next day settlement system. This meant that netted positions incurred as a result of payments exchanged on Day One were settled on Day Two. The suspension of payments by Herstatt on the morning of June 26 meant that Chase had a potential exposure. If Herstatt's June 25 payments out exceeded payments received by an amount greater than its June 26 collected balance at Chase, Chase's settlement of these payments on Herstatt's behalf on June 26 would have resulted in an overdraft on Herstatt's Chase account, leaving Chase as a creditor in the Herstatt bankruptcy. If Chase had protected itself by not settling Herstatt's position, then other banks expecting payments would not get them, leaving these banks exposed to losses unless sufficient credits previously given to their customers with respect to such payments could have been revoked. In either event, the failure of Herstatt could have caused significant problems, and perhaps potential insolvencies, for United States banks. Fortunately, it did not.

Since 1974, these risks have been substantially reduced with the advent of CHIPS same day settlement in 1981 and CHIPS loss-sharing and collateralization requirements in 1991, but they

have not been entirely eliminated. The Herstatt case dealt with a situation in which there was a risk to U.S. banks as a result of Herstatt's dollar payment activity, even though Herstatt was not a CHIPS participant. This risk might have been greater if Herstatt had been a direct participant in CHIPS and certainly would have been greater had Herstatt been a settling participant, through a New York branch.

E. The BCCI Experience

It appears that the BCCI banks in Luxembourg and the Caymans and their branches, subsidiaries, and agencies (including the U.S. agencies) cleared a significant amount of their dollar payments through Bank of America, but there is no indication that this resulted in any settlement problems for Bank of America or other CHIPS participants. Perhaps this is partly explained by the fact that the Federal Reserve had advance information of the timing of the closure of the BCCI banks. This information was apparently used to help insure that Bank of America and other U.S. banks were not left exposed when the BCCI banks were closed.⁹ For example, Bank of America could have managed BCCI payments in a manner that would assure that payments out never exceeded payments in by an amount greater than the collected balances of the BCCI banks. A system for insuring advance warning might be an important way of controlling systemic risk.

The BCCI case has also served to focus renewed attention on another feature of payment system risk, well known since the 1974 Herstatt failure, relating to the settlement of foreign exchange contracts. Since the two legs of currency trades are settled in the payment systems of two different countries, which may operate in different time zones, one party may pay out on one side of the contract before receiving a reciprocal payment in another currency from its counterparty. If the counterparty fails before making the reciprocal payment, the first party has a loss.

9. See *Hearings before the Senate Subcomm. on Terrorism, Narcotics and International Operations to Examine Allegations of Drug Trafficking and Money Laundering Activities in the U.S. by the Bank of Credit and Commercial International (BCCI), Focusing on Foreign Policy Implications*, 102d Cong., 1st Sess. (1991) (testimony of J. Virgil Mattingly, Jr., General Counsel, and William Taylor, Staff Director, Division of Banking Supervision and Regulation, both of the Board of Governors of the Federal Reserve System).

In fact, it appears that the Industrial Bank of Japan paid out \$30 million in Yen to BCCI in Japan before it could receive the reciprocal dollar payment in New York, due to the intervening closure of BCCI on July 5, 1991.

There has been an international initiative to deal with some aspects of payment system risk. The Bank for International Settlements through its Committee on Interbank Netting Schemes has recently set out minimum standards for the design and operation of netting schemes as well as principles for cooperative central bank oversight of such schemes. The major purpose of this effort is to minimize the possibility of settlement failures and thereby to limit systemic risk.

III. DEPOSITOR PROTECTION

One of the principal concerns of a host country is the protection of depositors against losses in the case of bank failure. I will examine this concern as it applies to branches and agencies of foreign banks and then briefly deal with the much simpler case of subsidiaries.

A. *Branches and Agencies*

Depositors, rightly or wrongly, have come to expect protection, and the failure to honor this expectation carries substantial political risk for incumbent politicians. In my view, depositors are unlikely to differentiate between losing funds in domestic branches of foreign banks and losing funds in domestic banks and will seek to hold politicians responsible in both cases. This political concern mainly involves domestic rather than foreign depositors, although some foreign depositors may be citizens of the host country, for example, a U.S. citizen living abroad, or may have an affiliation with residents in the host country, for example, a foreign subsidiary of a U.S. corporation.¹⁰

Some countries protect depositors in branches of foreign banks through providing deposit insurance. As previously discussed, until the passage of the FDIC Improvement Act of 1991, the United States required "retail" branches of foreign banks, those taking deposits under \$100,000, to be insured; now, such

10. The political concern with depositor losses involves corporations as well as individuals. Corporations fund politicians, and employees may bear part of the burden of corporate losses.

branches are prospectively prohibited.¹¹ Some other major industrialized countries such as Germany and the United Kingdom insure deposits in branches of foreign banks,¹² while others such as Japan do not. The provision of deposit insurance to depositors in branches of foreign banks creates a major problem for the host-country insurer since its insurance exposure is dependent on the efficacy of home-country regulation and on supervision of the bank. But even if the host country does not insure deposits in branches of foreign banks, it will still be concerned with the potential losses to uninsured branch depositors—particularly domestic depositors—that might arise from the failure of a foreign bank.

One way for the host country to limit insurance fund or depositor losses is to require branches of foreign banks to pledge readily marketable assets and to maintain the value of assets at a certain level in excess of liabilities, a “quasi-capital” requirement. These requirements would help to insure that if the foreign bank failed, sufficient branch assets would be available to the host-country authorities to cover losses. Federally-licensed and many state-licensed branches of foreign banks are subject to such requirements in the United States.

This approach is based on an important but questionable assumption—that the host-country authorities have or should have the legal power to seize branch assets and to control their disposition in the event of the failure of the foreign bank. If the home-country receiver asserts a claim to the assets of the entire bank, including the assets of foreign branches, the host country may not be able to dispose of the assets of the branch, at least not without causing conflict with the home-country receiver. This kind of problem has arisen in the BCCI litigation in the United States and abroad.

While BCCI did not have branches in the United States, the Luxembourg bank operated uninsured state-licensed agencies in New York and Los Angeles at the time of its failure in July 1991. Agencies, like branches, make loans and other investments and

11. Branches of foreign banks taking deposits in excess of \$100,000 can still be insured, but generally choose not to be to avoid the cost of paying the required premiums for such insurance that would have to be passed on to creditors through lower interest rates or to borrowers through higher interest rates.

12. Germany insures deposits in all currencies, while the United Kingdom only insures sterling deposits.

are offices of a bank. Both New York and California agencies can take deposits from foreign individuals and companies, and maintain credit balances for any borrower, that is, credit a borrower's account with loan proceeds. In addition, New York agencies can take domestic corporate deposits of \$100,000 or greater. While agencies in both states are legally prohibited from taking deposits from individual U.S. citizens or residents, it appears the BCCI agencies did so anyway.

When BCCI failed, its U.S. agencies failed with it. The U.S. assets of the failed BCCI banks, estimated at \$550 million, consisted only in minor part of the agencies' assets. Far more important were their alleged stockholdings in several U.S. banks, including First American, and clearing accounts at the Bank of America and some other banks. Claims against U.S. assets included somewhat less than \$20 million owed by the agencies to third parties (non-BCCI entities), as well as a \$200 million fine which the Federal Reserve Board sought to levy against BCCI for illegally acquiring certain U.S. banks. There was also the prospect of additional fines as a result of criminal prosecutions by federal and state authorities.

In a bankruptcy proceeding in the U.S. District Court, Southern District of New York, which was dealing with BCCI's United States assets, the liquidators of the Luxembourg holding company and the two subsidiary banks obtained, on August 2, 1991, a temporary restraining order (TRO) against any claims to BCCI's U.S. assets, including the assets of the agencies. The TRO was based on section 304 of the U.S. Bankruptcy Code that permits a court to enjoin the pursuit of claims against the U.S. assets of a bankrupt entity on the theory that the claims should be brought as part of a foreign proceeding, in this case, the insolvency proceedings in Luxembourg and the Cayman Islands.

On October 15, 1991, the foreign liquidators agreed to a consent order entered by the bankruptcy court that permitted the California and New York state regulators of the BCCI agencies to remove the agency assets from the bankruptcy court and to take control of them pursuant to ongoing state liquidation proceedings. The consent order further provided that the foreign liquidators would assert no claims to the agency assets in the state proceedings and that any surplus remaining after the liquidation of the assets and satisfaction of estimated claims on the agencies would be remitted to the bankruptcy court.

The consent order also dealt with another group of BCCI assets, deposits in BankAmerica International (BAI), Bank of America's New York Edge Act subsidiary, that served as a clearing bank for the two BCCI banks. BAI had interpleaded these assets, and they had become subject to the jurisdiction of the bankruptcy court. Under the terms of the consent order, the Luxembourg bank's deposits in BAI (SA accounts) were removed from the bankruptcy court's jurisdiction. The foreign liquidators further agreed not to assert claims to the SA accounts unless they failed to become subject to the New York state liquidation proceeding. Other BCCI assets, such as the alleged stock interests in various United States banks, remained subject to the jurisdiction of the bankruptcy court and to the operation of the section 304 TRO.

On December 19, 1991, the BCCI liquidators agreed to plead guilty to various federal and state criminal charges brought against the BCCI banks. These charges included a federal indictment alleging that BCCI secretly acquired control over several U.S. banks. Under the settlement, \$275 million in U.S. assets will be used to pay off U.S. creditors of the agencies, to pay part of the outstanding fines, and to increase the capital of U.S. banks illegally owned by BCCI. The \$275 million balance of the \$550 million in U.S. assets will be turned over to the consolidated bankruptcy proceedings in Luxembourg and the Caymans. On January 23, 1992, the U.S. District Court, Southern District of New York, which had jurisdiction over the bankruptcy proceedings, refused to upset the settlement on the grounds that it could not interfere with the federal prosecution, and on January 24, 1992, the settlement was approved by the U.S. District Court for the District of Columbia over the objections of various creditors.

The net effect of the United States proceedings, pending further appeals, was that \$275 million in U.S. assets was not consolidated with the worldwide receivership assets of the BCCI banks in the Luxembourg and Caymans proceedings and thus was not available to creditors of those banks. Also, it appears that the U.S. creditors of the BCCI agencies will receive full payment of their claims.

Certain conclusions can be drawn about these proceedings. As a threshold matter, it is unclear whether assets of agencies or branches of foreign banks are at all subject to the jurisdiction of the U.S. bankruptcy court; assets of failed banks clearly are not.

This uncertainty might partly account for the willingness of the BCCI liquidators to have agreed to the bankruptcy consent order of October 15, 1991. In addition, it appears that U.S. assets of failed foreign banks can be cut off from claims by foreign liquidators through the use of host-country criminal prosecutions.

If U.S. or other country assets of failed foreign banks are not fully consolidated in home-country foreign insolvency proceedings—what is called the “ring fence” approach—and such assets are substantial, the ability of a foreign receiver to reorganize a failed bank will be severely limited. While this was not a practical alternative in the BCCI case—earlier efforts to reorganize the bank with an infusion of capital from Abu Dhabi foundered—it could be a problem in future bankruptcies of multinational banks. Indeed, the possible need to reorganize a failed company is a significant rationale for the U.S. Bankruptcy Code’s section 304 proceeding. In fact, it was this concern that was behind the decision of U.S. authorities to assert jurisdiction over the London branch assets of Franklin National Bank when that bank was in danger of failing in 1974. The fact that the U.S. authorities had control over all of Franklin’s assets was an important factor in their ability to sell the troubled bank to European American Bank.

The failure to consolidate may also result in the inability of non-U.S. creditors to obtain the same pro rata share of all of the bank’s assets that they would have obtained if the assets were consolidated. While the creditors of BCCI’s U.S. agencies will be fully paid off, creditors in the foreign insolvency proceedings are expected to recover only thirty to forty percent of their claims. This is a somewhat arbitrary result.

Apart from the difficulties of preferring some creditors of a bank at the expense of others, the assets of an agency or branch of a foreign bank may have little to do with their actual business activities. It appears that the BCCI banks shifted assets among branches to avoid detection of insolvency. The difficulty of sorting out assets between various offices of a bank illustrates the need for a consolidated bankruptcy proceeding. A further complication arises insofar as the host country asserts jurisdiction over assets of a failed foreign bank that are within its jurisdiction but are not assets of the entities, an agency or branch, operating in its country. For example, part of the U.S. assets of the BCCI banks reportedly consisted of \$85 million of deposits of the Tokyo branch of BCCI Luxembourg. There is no clear rationale for

using these assets to satisfy claims of U.S. creditors of U.S. agencies or to make capital infusions into U.S. banks allegedly owned by BCCI, rather than using them to satisfy the claims of Japanese creditors against the Tokyo branch or the claims of worldwide creditors against the Luxembourg bank.

The strongest argument for the host country preserving the assets of a branch or agency of a failed foreign bank for local creditors is that the host country is at risk for the supervisory failures of the home country. This rationale is much stronger when the host country insures local depositors than when it merely seeks to protect their interests as in the case of the U.S. agencies of BCCI. The insurance commitment represents a potential exposure for the taxpayers of the host country. In my view, the claims of uninsured depositors should be fully consolidated with other claims to the worldwide assets of a failed bank. In addition, I do not believe that local assets should be subject to a ring fence just because the host country brings criminal actions against a failed bank. This creates a loophole to consolidation that can be easily exploited by a host country. Moreover, if criminal prosecution is the key to jurisdiction over assets, what if there are prosecutions in several countries? If the Japanese had criminally prosecuted BCCI, why should the United States rather than Japan use all of the U.S. assets (particularly those of the Tokyo branch) to satisfy the criminal fines?¹³

One might consider another approach to the deposit insurance problem: deposits in a branch of a foreign bank could be covered under the deposit protection scheme of its home country and the home country could be given jurisdiction over the worldwide assets of any failed bank. This would have the advantage of having the insuring country bear the risk for its own supervisory shortcomings and preserve the unity of the bankruptcy of the bank. But this approach raises problems of its own.

First and foremost, there is the issue of consumer confusion. Imagine a potential depositor winding his way through Wall

13. It is especially difficult to justify using U.S. assets to make capital infusions into banks owned by BCCI. This prefers creditors of these banks to creditors of the actual BCCI banks. Indeed, the FDIC has indicated that it will pay off all deposits (whether below or above U.S. insured limits) of the insolvent Independence Bank of Encino, California, allegedly owned by BCCI, because it expects reimbursement from the \$275 million of U.S. assets retained by the United States in the BCCI settlement.

Street, or perhaps even Atlanta, past the offices of various banks, including those of branches of foreign banks. A deposit in each domestic bank would be insured similarly under the United States deposit insurance scheme, but a deposit at each of the branches of foreign banks would be insured differently, according to the various schemes in place in the home countries of these banks. Even with full disclosure of the terms of such insurance, as to level of coverage, the degree of risk sharing by depositors, the types of deposits covered, and the speed and convenience of payouts, the consumer may be left with substantial confusion.¹⁴ These are sophisticated and complicated matters. In theory, this issue might be addressed by some harmonization of deposit insurance schemes through an international agreement, but this is not realistically achievable, in my judgment, in the foreseeable future.

Secondly, there is the ultimate question of whether the home-country insurance fund obligation will actually be honored—this issue has not been free from doubt even in the United States. It would certainly be a major concern for host countries where the bank's home country had a history of economic difficulty.

B. The Need for International Solutions

An international agreement is seriously needed in this area. At the outset, there should be agreement as to what to do when the local entity of the failed foreign bank is not insured. In my view, there is a strong case for home-country bankruptcy jurisdiction for all uninsured claims, including those of government authorities. Also, agreement is needed as to whether host countries should have any claim to jurisdiction over assets other than those of the local entity of the failed bank, for example, clearing accounts of the foreign bank. Again, in my judgment, these assets should be part of the home-country bankruptcy proceeding.

14. It could be argued that the rational consumer would also want information about how the deposit insurance "system" works in practice. For example, does the foreign country ever liquidate failed banks, or does it routinely bail them out through capital infusions or central bank loans? But these issues are equally important where deposits in branches of foreign banks are insured by the host country. Deposits in excess of host-country insured amounts may be protected to a greater or lesser degree depending on the bailout policies of the home country.

While host countries may be able to ring fence all local assets through brute force, this may be done at the expense of engendering conflict with home-country receivers, as well as foreign creditors, which in some cases may be government authorities. Further, host countries that prefer a ring fence in a case where they are in surplus—host-country assets exceed local claims (the U.S. with respect to BCCI)—may prefer consolidation when they are in deficit. In the context of an international agreement, countries could define their general and long-term interests rather than responding to the exigencies of a particular case.

There are two principal approaches to the deposit insurance issue: (1) host-country deposit insurance and host-country bankruptcy jurisdiction over the assets of insured branches or other insured entities of failed foreign banks, and (2) home-country deposit insurance and home-country bankruptcy jurisdiction over the worldwide assets of failed foreign banks. While each approach has its own problems, I think the former is probably more realistic. However, this choice should be settled by international agreement.

The United States has chosen a third path: not permitting insured retail branches of foreign banks. I think this is ill-advised for the reasons previously stated. It deprives depositors and their insurers of the backing of the worldwide capital of strong foreign banks. These creditors can now only look to the capital of U.S. subsidiaries. Also, this approach limits the competitiveness of foreign banks in U.S. markets. Foreign banks with retail deposit funding will have less lending capacity since they are forced to lend off the capital of subsidiaries rather than worldwide capital. This is not in the interest of potential U.S. borrowers.¹⁵

C. *Subsidiaries*

Subsidiaries raise no major problems with respect to depositor protection. Subsidiaries are supervised and insured by the host country, and the host country has jurisdiction over the bankruptcy of its own domestic banks whether or not they are

15. This approach also risks foreign retaliation by the European Economic Community (EEC) and other countries. See Hal Scott, *Shackling Foreign Banks is Bad Policy*, AM. BANKER, Apr. 30, 1991, at 4.

owned by foreign banks. As in the BCCI case, various claims may be asserted against the failed bank's interest in its foreign subsidiaries. For example, there are claims against BCCI's interests in various United States banks allegedly owned by BCCI, but these claims only concern ownership of the banks, not their supervision or solvency.

While this completes my review of the three areas involving host-country supervision of foreign banks, safety and soundness, systemic risk, and depositor protection, let me briefly raise a troublesome issue that might have arisen in the BCCI affair but did not—what to do with a bank that operates unlawfully in a host country but is solvent: BCCI was both engaged in unlawful activities and was insolvent. Crime did not pay in its case, but it might in the future.

IV. CLOSING AN UNLAWFUL BUT SOLVENT BANK

One of the disturbing aspects of the BCCI affair, and the one that has received the most attention from the press, is that the banking organization engaged in illegal activities, including money laundering, unlawful acquisitions of banks, bribing of foreign officials, and embezzlement, just to name a few. The initial desire of supervisors to close down BCCI seemed to be prompted as much by the need to stop these activities as from concerns with its solvency. But it was only after an outside audit of BCCI showed its banks to be insolvent that BCCI's operations were closed.

Should the United Kingdom have closed down the U.K. branches of BCCI, and should the United States have closed down the U.S. agencies, if the BCCI banks had been solvent? If the profitable operations of a bank are closed by host countries, the bank as a whole may be rendered insolvent. Profits are lost, employees leave, credits are not supervised, and funding may disappear. The result may be that the bank's creditors or their insurers, both inside and outside the countries in which operations are closed, may pay the price for stopping the bank's illegal activities. Perhaps a better approach, but one that would require cooperation between a bank's home country and the host countries concerned with illegal activities, would be to replace the management and conceivably the owners of the unlawful but

solvent bank or to gradually phase out its host-country operations.¹⁶ This remains an issue for the future.

V. INTERNATIONAL STANDARDS

As I have indicated throughout this lecture, there is a strong need for the further development of international standards regarding the supervision of banks operating abroad, especially with regard to their branches. New international standards are needed for safety and soundness, particularly if we are to avoid unilateral actions in the name of safety and soundness that are actually motivated by protectionism. A procedure to insure effective consolidated supervision by one country is also needed. Systemic risk, particularly with respect to the payment system, remains an important subject for international action. Issues of whether deposit insurance should be provided by host or home countries, and to what extent, as well as the corollary problem of bankruptcy jurisdiction, are additional matters which must be dealt with through an international agreement.

In fact, at this very moment active negotiations are taking place within the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) on the subject of trade in services, including banking. But these negotiations have focused on competitive rather than supervisory issues. Important work on supervisory issues continues to be done through the Bank for International Settlements (BIS) Committee on Banking Regulations and Supervisory Practices, now chaired by Mr. Corrigan of the New York Federal Reserve Bank. Still, there is a question of how far informal agreements among central bankers can go; they certainly cannot deal with major changes in deposit insurance or bankruptcy jurisdiction. Also, it is highly questionable whether supervisory issues can be bifurcated from competitive ones. They are often directly interrelated.

My view is that competitive and supervisory issues requiring international agreement should be negotiated in one broad forum, either GATT or the Organization for Economic Cooperation and Development (OECD). Both organizations, unlike BIS, are dominated by political officials of member

16. The U.S. does appear to have phased out certain agencies of BCCI before the BCCI banks were closed.

countries whose support will be crucial if agreements are to be implemented in domestic legislation.

GATT has the disadvantage of including all countries, many of whom have little interest in and indeed oppose liberalizing rules for banking services. This will make it harder to reach agreement on issues that are most important to relations between developed countries. OECD, on the other hand, is comprised of twenty-four countries at relatively similar levels of development. Also, GATT has a very broad trade agenda that may lead to undesirable trade-offs on banking for gains on trade in goods, such as agriculture.

GATT does have a decided advantage over OECD insofar as it has an effective Secretariat and experience with enforcement of international rules. While OECD rules are legally binding on member states, the OECD lacks a strong mechanism for settling disputes.

The BIS could continue to play a key role, taking the lead on safety and soundness and systemic risk issues. Its proposals could be submitted to the broad forum, GATT or OECD, as the case may be, for further consideration in the context of other issues that might be worked on by the broad forum itself, such as depositor protection and competition.

Let me conclude by saying that new efforts in the international arena would have been justified even without the advent of the BCCI affair, though BCCI has demonstrated the relevance and importance of such efforts. In going forward, we must focus on general questions important to the conduct of international banking and avoid overreacting to the particular and highly unusual nature of many aspects of the BCCI affair.