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Committee on Banking Regulations & Supervisory Practices 1975

Basel Committee on Banking Supervision (BCBS)

COMMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES

Confidential

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Report to the Governors on the supervision of banks' foreign establishments

Introduction

The object of this report is to set out certain guidelines for co-operation between national authorities in the supervision of banks' foreign establishments, and to suggest ways of improving its efficacy.

Three types of foreign banking establishment are distinguished: branches, which are integral parts of a foreign parent bank; subsidiaries, which are legally independent institutions incorporated in the country of operation and controlled by one foreign parent bank; and joint ventures, which are legally independent banks incorporated in the country of operation and controlled by two or more parent institutions, most of which are foreign and not all of which are necessarily banks.

In addition, banking supervision is considered in this report from three different aspects: liquidity, solvency and foreign exchange operations and positions. The Committee recognises that these different aspects are to some extent overlapping. For instance, liquidity and solvency problems can shade into one another; and both liquidity and solvency considerations are among the reasons why countries supervise their banks' foreign exchange operations.

The need for co-operation

The Committee is agreed that the basic aim of international co-operation in this field should be to ensure that no foreign banking establishment escapes supervision.

It is also agreed that each country has a duty to ensure that foreign banking establishments in its territory are supervised; and that in the case of joint ventures involving parent institutions in more than one country there is no practicable alternative to supervision by host authorities.

Acceptance that supervisory authorities are responsible for ensuring that foreign banks in their territory are supervised will not, however, necessarily preclude there being gaps in the supervision of such establishments. Thus, owing to differences in definition, a particular foreign establishment may be classified as a bank by its parent, but not by its host, supervisory authority; and in some countries not represented on the Committee there may be no supervision whatever of foreign banking establishments.

Furthermore, it is desirable not only that all foreign banking establishments are supervised but that this supervision is adequate, judged by the standards of both host and parent authorities. In that connection the Committee noted that host authorities are interested in the foreign banks operating in their territories as individual institutions and from the point of view of what happens in their own markets, while parent authorities are interested in them as parts of larger institutions which they are responsible for supervising.

For a variety of reasons, therefore, adequate supervison of foreign banking establishments, without unnecessary overlapping, calls for contact and co-operation between host and parent supervisory authorities. It is one of the Committee's purposes to foster co-operation of that kind among its member countries. In addition, the Committee considers that any guidelines for co-operation it may agree on should be communicated to other countries with a significant rôle in international banking, in the hope of obtaining their co-operation too. The Committee has already established contacts with the supervisory authorities of a number of such countries and, if the Governors accept this report, will consider which other countries it might approach.

Supervisory responsibilities and interests of host and parent authorities

Having agreed on the need for contact and co-operation between supervisory authorities, the Committee went on to consider the extent to which the division of responsibilities for supervision could be codified. Their discussions showed that it is not possible to draw up clear-cut rules for determining exactly where the responsibility for supervision can best be placed in any particular situation. Nevertheless, the Committee was able to agree on a number of general guidelines in this field.

<u>Liquidity</u>. In managing their liquidity foreign banking establishments rely heavily on local practices and comply with local regulations, including those established for monetary policy purposes. Responsibility for supervising their liquidity must therefore rest in the first place with the host authority. Moreover, in practice, only the authority on the spot can carry out the continuous supervision of liquidity which may from time to time be required. For the management of liquidity in foreign currencies, and especially the currency of the parent bank, local practices and regulations may be less important and not all host authorities accept the same degree of responsibility.

In the case of a foreign branch, liquidity cannot be judged in isolation from that of the whole bank to which it belongs. This applies particularly when a branch is free to deposit funds with its parent bank. Furthermore, the parent authority, in controlling the liquidity of the parent bank, must take account of calls that its foreign branches might make on its liquid resources. For these reasons the liquidity of foreign branches is a matter of concern to parent authorities also.

In the case of foreign subsidiaries or joint ventures, too, parent authorities may be concerned. For example, such banks may have stand-by facilities available to them from their parent institutions. In such cases the parent supervisory authority concerned ought to be informed by the host authorities of the importance they attach to these stand-by facilities in judging the liquidity of the banks in question. Moreover, though the legal position of foreign subsidiaries and joint ventures is different from that of foreign branches, parent authorities cannot be indifferent to the moral responsibilities of the parent institutions.

<u>Solvency</u>. In the case of solvency controls, there is again some sharing of responsibility for supervision between host and parent authorities, with the emphasis varying according to the type of establishment concerned. For foreign subsidiaries and joint ventures, primary responsibility rests with host authorities; but, in addition, parent authorities must take account of the exposure of their domestic banks' foreign subsidiaries and joint ventures because of those parent banks' moral commitments to those foreign establishments. For foreign branches,

solvency is indistinguishable from that of the parent bank as a whole. It is therefore essentially a matter for parent supervisory authorities. The "dotation de capital" imposed by the host authorities in certain countries on foreign branches is above all intended to do two things to oblige foreign branches that set up in business in those countries to make a certain minimum investment in them; and to equalise competitive conditions between foreign branches and domestic banks.

Foreign exchange positions. Banks' foreign exchange positions are supervised partly for prudential reasons, partly for balance-of-payments reasons and partly for the purpose of maintaining orderly market conditions. So far as concerns prudential supervision the considerations set out in the previous paragraphs govern the division of responsibility, while the other matters are by definition the concern of host authorities.

Aids to co-operation

The Committee considers that, in seeking to improve the supervision of banks' foreign establishments and to implement the guidelines for co-operation set out earlier in this report, efforts should be made to remove, or at any rate reduce, certain restraints which at present hamper such co-operation. In particular, it believes that action could usefully be taken in the following areas:

1. Direct transfers of information between supervisory authorities. Parent authorities may wish to obtain copies of reports submitted to host authorities, particularly in cases where host authorities waive certain requirements in respect of foreign banks established in their territory, where their control requirements are less stringent than those of the parent authorities or where they take into account, for prudential purposes, commitments to such banks by their parent institutions. Normally they should obtain such reports direct from the banks concerned, provided that host authorities are previously informed. At the same time it would be desirable that host authorities be permitted to transfer copies of such reports to parent authorities when circumstances so warrant. The Committee is aware that such transfers of information are often impossible because of banking secrecy laws in host countries;

but many of its members consider that the operation of these laws should over time be modified so as to permit them. (This same point also applies in the case of the proposals in 2 and 3 below.) The Committee wishes to emphasise that the sole purpose of such transfers would be to facilitate prudential control of banks and that in no circumstances would they be directed to the affairs of individual customers.

2. Direct inspections by parent authorities of their domestic banks' foreign establishments. These are likely to be particularly helpful for purposes of solvency control, including control of banks' foreign exchange positions. Such inspections already take place, sometimes on an informal basis and sometimes as a result of formal reciprocal agreements between pairs of countries. Wherever possible steps should be taken to facilitate such arrangements, if necessary by amendment of legislation.

3. Indirect inspections of foreign banking establishments by parent authorities through the agency of host authorities. Host authorities that do not allow direct inspections by parent authorities of their domestic banks' foreign establishments should give favourable consideration to carrying out, at the request of the parent authorities concerned, specific inspections of foreign banks operating in their territory and to reporting their overall findings to them.

The Committee believes that in seeking to remove restraints on transfers of information between, and foreign inspections by, supervisory authorities it would be wise to begin with foreign branches, where the problems presented appear less difficult than with subsidiaries and joint ventures.

The Committee asks that the Governors, if they are in agreement with the recommendations of this report, should take advantage of any opportunities that present themselves to further the removal of restraints on co-operation.

26th September 1975