CROSS-BORDER BANKING SUPERVISION

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Outline

• Cross-border banking: opportunities, challenges
• What cross-border supervision is about
• Home and host responsibilities
• Home-host relationships
• MoUs and colleges of supervisors
• Crisis management
• Conclusions
Cross-border banking brings opportunities...

**BANKS**
- Market opportunity
- Diversification
- Economy of scale
- Customer led
- Arbitrage

**SUPERVISORS**
- Financial deepening
- Increase competition
- Innovation
- Deepen pool of skills
- Enhance technology
...but also challenges

**BANKS**
- Regulatory burdens
- Establishing reputation
- Risk of marginal portfolios
- Over rapid expansion
- Parental support

**SUPERVISORS**
- Contagion potential
- Volatility potential
- Increased resource demands on supervisor
- Access to group wide information
- Arbitrage
Cross-border banking
The clash of private and public interests

**International banking groups**
- be profitable!
- avoid burdens from regulation
- benefit from regulatory loopholes and State protection

**Home and hosts supervisors**
- Know banks’ risks
- Opine on banks’ viability
- Apply corrective measures
Regulatory framework and powers also in a cross-border context

In the absence of a truly and fully market discipline in the banking industry, enhancements to the legal framework have to provide supervisors with all the powers so “supervisory discipline” can act as a “proxy.”

- Control of entry and expansion of activities
- Ability to impose supervisory discipline
- Powers to obtain all relevant information
What cross-border supervision is about

• First, no foreign banking establishment should escape supervision.
• Second, the supervision of the foreign establishment should be adequate.
• Elements:
  – Powers and resources to carry out home and host supervisory responsibilities
    • The home supervisor practice solo supervision on the parent bank and consolidated supervision on the banking group.
    • The host supervisor practice solo supervision on branches and subsidiaries.
  – Arrangements for home-host cooperation and information sharing
  – Ability to carry on coordinated remedial actions.
  – Ability to deter cross-border corporate structures that hinder effective supervision.
• Both home and host determine whether their counterparties practice effective consolidated or solo supervision over the foreign branches and subsidiaries of common interest.
A host of issues around supervising cross-border banking groups

• The location of the home supervisor (BCCI case)
• Licensing of internationally active banks
• Effective supervision of foreign branches and subsidiaries
• Cross-border compliance with prudential standards
• Information flow in the banking group
• Effectiveness of onsite inspections
• Special cases: shell banks and parallel owned banks
• Cross-border remedial actions
• Resolution of international banks
• Liquidation of international banks
Subsidiaries or branches?

• Subsidiaries offer more control to the host than branches
  – Branches put a supervisory burden given the absence or reduced effectiveness of some prudential tools
    • Such as capital and liquidity requirements
  – …and constraints on the use of traditional supervisory tools and resolution options.

• Subsidiaries allow a clearer definition of home and host supervisory responsibilities than branches
  – Branches are not stand alone legal entities – a supervisory challenge

• Most global banks prefer branches to subsidiaries
  – Branches are administratively less expensive to operate
  – Branches provide the parent bank with more balance sheet flexibility.
Home and host responsibilities

Core Principle 12 – Consolidated supervision (considered from its cross-border perspective) “An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.”
Home/host responsibilities: the Basel standard
(1992 reformulation of the Concordat)

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

- Impose prudential standards on consolidated basis; oversee group risk management and internal control
- Collect consolidated financial and prudential information as well as separate reports from foreign subs and branches
- Perform on-site inspections of foreign establishments at a frequency based on their size and risk profile
- Limit or close activities of foreign establishments if concerns arise
Home and Host Responsibilities

PRACTICAL CONSIDERATIONS

• Supervision performed by host supervisors is essential:
  – Host supervisors are responsible for the supervision on an individual or sub consolidated basis of the banks operating in their country
  – Host supervisors have the legal prerogatives and authority to adopt prudential measures in cases of contingency or crisis.
  – Given their proximity, hosts have better knowledge of local markets and a greater capacity to assess the risks of the bank’s activity in their country.

• The home supervisor has a dual function:
  – It is the “host” supervisor of the parent institution.
  – It is responsible for the revision of the consolidated statements, using valuation criteria in harmony with those applied by the parent institution.

• The effectiveness of home supervision on a consolidated basis depends on the effectiveness of host supervision of subsidiaries
Home-host relationships

• **Core Principle 13 – Home-host relationships:**
  “Home and host supervisors of cross-border banking groups *share information and cooperate* for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.”
The aim of cooperation and information sharing between supervisors

• To facilitate compliance with the responsibilities each authority has as home or host supervisor
  – Host supervisors perform the individual supervision of authorized subsidiaries in their country.
  – The home supervisor has a dual function:
    • Individual supervision of the parent institution.
    • Supervision of the group on a consolidated basis, ensuring its solvency and internal control.

• **Confidence** and respective knowledge of supervision models is needed for a fruitful dialogue between supervisors, and this takes time.
Elements of an effective information exchange

• A general framework for sharing information between supervisors that ensures:
  – Confidentiality
  – Exclusive use of the information for supervisory purposes
  – Reciprocity

• A general framework that favors home supervisor visits when needed

• Absence of hindrance in host countries for the parent bank to have access to information from their foreign branches and subsidiaries.

• Timely notification between supervisors of significant developments

• Practical cooperation arrangements
  – To be agreed on a case by case basis—working from general principles does not offer great solutions.
Cross-border information requirements of home and host supervisors differ

• The home supervisor needs information of all the group subsidiaries in its capacity as supervisor on a consolidated level.

• The natural source of information for the home supervisor is the parent institution.
  – Information should flow appropriately and unrestrictedly from subsidiaries and branches to the parent (and vice versa)
  – If the parent does not receive adequate information from subsidiaries it can not manage adequately the group.
    • To carry out effective cross-border supervision, it is essential that first the parent bank is able to produce consolidated management information.
    – If the parent does not receive information, the home supervisor cannot perform its function of supervisor on a consolidated basis.

• The host supervisor must be able to ensure that the capital and risk management of the subsidiary is appropriate.
  – The host supervisor needs information on the group as far as that is relevant in this connection.
Drivers of cooperation and information sharing between supervisors

• A careful consideration should be given to the incentives of other supervisors to share, overstate, delay, and hide information

• These incentives may be framed by topics such as:
  – The materiality of the host’s operations to the banking group
  – The systemic nature of the foreign operations in the host jurisdiction and the relative importance in the banking group
  – Host supervisors’ ability to ring-fence operations
  – Supervisors’ willingness to surface problems
  – Lack of accountability if supervisory cooperation fails

…and many others.
Home-host Relationships

PRACTICAL CONSIDERATIONS

• Cooperation agreements have an obvious limit: supervision is a sovereign matter and should be recognized as such
• Effective cross-border supervision depends on access to information
  – Privacy laws and other regulations that prohibit the flow of information
  – Professional secrecy must be ensured
• Different legislative frameworks that are difficult to reconcile
  – For example, establish consolidated prudential reports when host countries apply different regulations
• Banking groups and complex corporate structures
• The "risk of distance," i.e., difficulty to supervise activities that are outside the natural reach.
• Foster mutual trust and recognition from supervisors
• Build up and retain adequate resources for cross-border supervision
• Establish instruments to support information exchange and cooperation (MoU, Colleges)
In all, cooperation and collaboration are the foundations of the home-host dialogue.

Consolidated supervision and individual supervision are complementary tasks.

Mutual trust and professionalism.

Arrangements for supervisory cooperation and information exchange.

Effective home-host relationship.
Memorandum of Understanding
What should it cover? How to use it?

Must be used

- Description of Group and relevant authorities.
- Cooperation in ongoing and crisis supervision.
- Responsibilities of authorities.
- Confidentiality.

- Bilateral or multilateral.
- Not legally binding.
- May be a condition of cooperation.
Colleges of Supervisors

• Intellectually appealing channels of cooperation
  – “The home supervisor establishes bank-specific supervisory colleges for banking groups with material cross-border operations” (CP13, EC1)

• But colleges have not yet been tested sufficiently
  – Supervisory colleges have entered the policy debate without their effectiveness being adequately assessed.

• Even in the presence of colleges, bilateral relationships are still essential.
  – They will allow solving specific problems.
Colleges may raise difficult questions of core and periphery relationships.
Crisis management

“Banks are international in life and national in death”
(Charles Goodhart and Mervyn King)

• Financial crisis management remains a domestic competence
• Supervisory cooperation tends to fade away as the health of all or part of a cross-border banking group deteriorates.
  – A key lesson learned from the current global financial crisis
  – Interests of the home and host authorities diverge, incentive conflicts escalate and supervisory cooperation breaks down.
Cross-border cooperation on crisis management

- Commitment to cooperation between relevant authorities, including supervisory agencies, central banks and finance ministries
  - Making advanced preparations for dealing with financial crises and in managing them.
- Commitment of national authorities from relevant countries to meet regularly alongside core colleges
  - To consider together the specific issues and barriers to coordinated action that may arise in handling severe stress at specific firms
  - To share information where necessary and possible, and to ensure that firms develop adequate contingency plans
  - FSB sponsored “Crisis Management Groups”
  - EU sponsored “Cross-Border Stability Groups”
- The development of crisis management and resolution arrangements need to be in place to achieve effective cross-border supervision.
Cross-border supervision

Final list of open issues for discussion

• Asymmetric relationships (e.g., when a large banking group has a small foreign subsidiary)
• What legal barriers exist to cooperation and how to remove them
• Adherence to core standards with non-discriminatory treatment of domestic and foreign banks
• Differences in methods and practices between supervisors can be very fruitful, but sometimes creates tensions
• Gaps or differences in skills and resources between home and host jurisdiction can be problematic
• Time invested in bilateral relationships will bear fruit
• Agreement on procedures for rapid and predictable resolution
• Framework for burden sharing and allocation of responsibilities
Take away

• Effective cross-border supervision starts by a well understanding of home and host responsibilities.

• Improved cooperation and information sharing is of central importance, both in normal times and in crisis situations.

  And this takes time to develop

• A concluding question that cannot remain unanswered.

  “Can I carry out an adequate and timely assessment of all significant aspects affecting safety and soundness of all banks and banking groups that fall under my jurisdiction, wherever they operate and in accordance with the techniques that are central to my model of supervision?”