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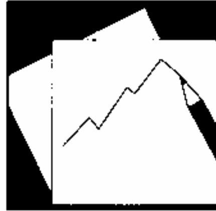

IMF Working Paper

Foreign Bank Supervision and Challenges to Emerging Market Supervisors

Inwon Song

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Foreign Bank Supervision and Challenges to Emerging Market Supervisors

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Abstract

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The increased presence of foreign banks in a country's domestic banking system necessitates the development of effective cross-border prudential supervision where the consolidated supervision is the essential element. This paper presents foreign bank supervision in terms of division of responsibilities between the home and host countries, consolidated supervision, quality of home-country supervision, memoranda of understanding (MOUs), and "ring-fencing" of banks. A number of challenges which foreign banks bring to emerging market banking supervisors are also discussed. The paper also provides surveys of country cases.

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I. Introduction

Foreign banks' operations in the emerging market banking system increased dramatically during the second half of the 1990s.[2] For example, in Eastern Europe, the share of banking assets under foreign control increased from 25 percent in 1995 to 30 percent in 2000. Much the same occurred in Latin America, with almost 40 percent of total bank assets controlled by foreign banks in 2000, following a series of cross-border mergers and acquisitions. Although foreign banks have played a smaller role in Asia than in Eastern Europe or Latin America, after the Asian crisis, foreign bank control in the East Asian banking market increased from 5 percent in 1995 to 6 percent in 2000.[3] Indonesia, Korea, and Thailand have raised allowable foreign equity levels in local banks to 100 percent. The Philippines now permit 60 percent foreign ownership.[4]

For the developed markets, foreign bank expansion had also been significant for the past decade. For example, foreign-controlled ownership in the United States increased from 8 percent in 1995 to 22 percent in 2000, primarily owing to the expansion of European banks in the United States.[5]

The total number of foreign banks in low-income countries more than tripled from 42 in 1995 to 144 in 2000. Foreign banks represent 18 percent of the total numbers of banks in these low-income countries in 2002, up from 5 percent in 1995.[6]

The growing presence of foreign-owned financial institutions, especially banks (see Box 1), raises a number of important issues. The arguments for and against foreign bank entry and foreign banks' impact on the efficiency and stability of domestic banking systems, continue to be subjects of debate. Factors that have stimulated international banking institutions to expand into overseas markets and those that have influenced host countries' decisions to accept foreign financial institutions are closely related to these arguments. (See Appendix I for the pros and cons of licensing foreign banks.)

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[2] This does not mean that foreign bank expansion is a relatively new phenomenon. Several countries have a long tradition of foreign-owned banks, with some reducing the numbers of foreign banks owing to waves of nationalistic tendencies in the 1950s through 1970s, but later showing increasing openness during the 1990s.

[3] De Nicoló and others (2003), pp. 15–18.

[4] Hawkins and Mihaljek (2001), p. 24. The Monetary Board of the Philippines may authorize a foreign bank to acquire up to 100 percent of the voting shares of a bank.

[5] De Nicoló and others (2003), p. 17.

[6] Claessens and Lee (2002), pp. 2–3.

Box 1. Forms of Foreign Bank Entry

Each host country determines the types of foreign bank operations it will permit. Desired forms of entry may vary from bank to bank and from country to country, depending upon business-strategy considerations and host country-laws and banking structures.

Banks initially extended their services abroad in order to assist their home-country customers with international transactions. With a growing understanding of foreign markets and a more developed network of relationships with local financial institutions, some banks subsequently increased the range of their operations by adding local customers. Following this pattern, foreign banks would first establish representative offices. At a later stage, they would open branches and, eventually, establish subsidiaries.[1]

Today, the actual pattern of foreign bank entry depends on a wider range of factors. In particular, the profit opportunities in the destination market have become a key factor in determining the pattern of foreign bank entry. As a result, forms of foreign participation have become more varied, including full acquisition, targeted purchases of specific activities, joint ventures, alliances with local banks, and outsourcing of administrative and financial services.[2]

Representative offices are generally prohibited from performing any banking operations. They do, however, offer opportunities for contracts with the parent bank and its clients concerning a variety of commercial and financial business that relates to the foreign market.

A foreign branch is an overseas office of a bank incorporated in a foreign country and constitutes a higher level of commitment than a representative office. Foreign bank branches are typically involved in wholesale banking.

Bank subsidiaries are separately incorporated from the parent bank, whose financial commitment to the subsidiary consists of the capital invested. Subsidiaries are usually involved in retail banking markets. However, in some countries such as the United Kingdom, subsidiaries are often involved in wholesale investment banking operations.

Establishing an affiliate relationship or participating in a joint venture can be another way to engage in foreign expansion. This usually involves taking minority stakes in local entities, and the level of involvement in the management of the local banks by the foreign bank is normally low.

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[1] Discussions on the forms of foreign bank entry, especially branches and subsidiaries, see Clarke, Cull, and Peria (2001), pp. 29–31.

[2] Hawkins and Mihaljek (2001), pp. 25–26.

The increased presence of foreign banks in the domestic banking system necessitates the development of effective cross-border prudential supervision. Although the key objective of the supervisors of internationally active banks has been to ensure that no activity of these banks escapes effective supervision and that coordinated remedial action can be undertaken when necessary, several instances have occurred in which institutional structure and legal arrangements escaped effective prudential supervision.[7] One of the most glaring was the failure of Bank of Credit and Commerce International (BCCI) in 1991. In the ensuing years, close cooperation between home-and host-country authorities with continuous sharing of information became far more important. Recent development of foreign banks in Argentina also could raise many supervisory issues deserving interesting discussions.

Consolidated supervision is an essential element of effective cross-border prudential supervision. This includes the ability to review both banking and nonbanking activities conducted at both domestic and foreign offices. Cooperation across markets to strengthen supervision of financial conglomerates has also been enhanced, because financial groups could pose significant international problems. Recently, the mechanisms to prevent money laundering and combat terrorism financing (AML/CFT) have become an integral part of prudential supervision. These efforts are subject to increasing standardization by the international community and also have a direct impact on the way foreign banks are supervised.

The rest of this paper is structured as follows. Section II addresses foreign bank supervision in terms of the division of responsibilities between home and host country, consolidated supervision, quality of home-country supervision, a memorandum of understanding (MOU), and ring fencing of banks. Section III explores a number of challenges that foreign banks bring to emerging market banking supervisors, and Section IV concludes. Arguments for and against foreign bank entry in domestic market and country surveys are presented in the appendixes.

II. Foreign Bank Supervision

A. Home/Host Country Division of Responsibilities

Banking supervisors have long been aware of the potential problems associated with the cross-border banking activities, which have derived from the growing presence of foreign banks in many emerging markets. Of late, several instances have occurred where institutional structure and legal arrangements have escaped effective prudential supervision. This has happened even though supervisors of internationally active banks have tried to ensure that no activity of these banks escapes effective supervision, and that coordinated remedial action can be undertaken when necessary. Part of the problem is that various types of corporate

[7] Mathieson and Roldos (2001), p. 27.

structures across international borders can be used to escape regulations and effective supervision. While supervising banking institutions across borders can be difficult, the cost of not adequately supervising them can indeed be greater.

To deal with this problem, the Basel Committee on Banking Supervision has developed basic principles and standards on many aspects of supervision and regulation of cross-border banking.[8] Its approach was based on two basic principles: that no foreign banking establishment should escape supervision; and that supervision should be adequate. To this end, the Basel Committee believes home and host authorities should both give their explicit permission for the setting up of an establishment abroad. Further, the Committee is of the opinion that the home authority should be able to refuse the establishment of a branch or subsidiary of a bank jurisdiction, suspected to be inadequately regulated (See Box 2 for "Minimum Standards" to reinforce the Concordat). See Appendix II for country cases on whether permission of foreign supervisor is required in licensing foreign bank branches or subsidiaries.

Improvement in the supervision of cross-border banking was made in 1996. At the International Conference of Banking Supervisors in June 1996, organized by the Basel Committee, the representatives of about 140 countries endorsed a report on the "Supervision of Cross-Border Banking" prepared by a joint working group of the Basel Committee and members of the Offshore Group of Banking Supervisors.[9] The report contains a number of recommendations aimed at removing obstacles to the implementation of effective consolidated supervision. In particular, it reinforces the principle that home country supervisory authorities should have full access to necessary information, and it sets out ways in which they can conduct cross-border inspections at branches or subsidiaries owned by banks headquartered in their jurisdictions.

To be consistent with the Basel Concordat and its successors, including "The Supervision of Cross-Border Banking," the "Core Principles for Effective Banking Supervision" set forth a number of principles regarding cross-border banking supervision in 1997. Principles 23 (Global Consolidation) and 24 (Information Exchange with Host Country Supervision)

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[8] The "Report on the Supervision of Bank's Foreign Establishments," was published in 1975 and called The Basel Concordat. In May 1983, "Principles for the Supervision of Bank's Foreign Establishments" replaced the 1975 Concordat. In April 1990, a "Supplement to the Concordat" was issued to define more clearly how the Concordat was to be implemented in practice, seeking to ensure that adequate information flows between supervisory authorities.

[9] Basel Committee on Banking Supervision (1996).

incorporate the obligations of home country supervisors, and Principle 25 (Supervision of Foreign Establishments) outlines the obligations of host country supervisors.[10]

Box 2. "Minimum Standards" to Reinforce the Concordat

In July 1992, following the BCCI incident, the Basel Committee issued the standards that are as follows.[1]

- All international banking groups and international banks should be supervised by a home country authority that capably performs consolidated supervision.
- The creation of a cross-border banking establishment should receive the prior consent of both the host country supervisory authority and the bank's and, if different, the banking group's home country supervisory authority.
- Supervision authorities should possess the right to gather information from cross-border banking establishments of the banks or banking groups for which they are the home country supervisory authority.
- If a host country authority determines that any one of the foregoing minimum standards are not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns.

[1] Basel Committee on Banking Supervision (1992).

In May 2001, the Basel Committee on Banking Supervision reinforced its work on the international coordination of the activities of supervisory authorities. A report, "Essential Elements of a Statement of Cooperation between Banking Supervisors," prepared by the Working Group on Cross-Border Banking, was released. The report provides a framework

[10] According to the recent results of Basel Core Principle (CP) assessments undertaken for 60 countries as of December 2001, for CP 23, almost 42 percent of countries assessed are compliant or largely compliant, while 30 percent of them are noncompliant or materially noncompliant. In the case of the CP 24, 54 percent of countries are compliant or largely compliant, while 30 percent are noncompliant or materially noncompliant. On the other hand, CP 25 shows a higher level of compliance. Seventy percent of countries are compliant or largely compliant, while 28 percent are noncompliant or materially noncompliant (see IMF 2002).

for agreements between supervisors to share information on the basis of mutual trust, where circumstances justify it.[11] This report sets out essential elements in the area of sharing information regarding the following issues: (i) the authorization process; (ii) the ongoing supervision of their cross-border establishments; (iii) on-site inspections; (iv) protection of information; and (v) ongoing coordination (refer to Box 3).

Recently, taking into account the issues raised by the implementation of the proposed Basel Capital Accord II, the Basel Committee on Banking Supervision issued "High-Level Principles for the Cross-Border Implementation of the New Accord" in August 2003. The Basel Committee believes that fostering closer practical cooperation between home and host supervisors is essential to effectively implement the Basel Capital Accord II.[12] Regarding banks' cross-border electronic banking activities, the Basel Committee on Banking Supervision reasserted the home/host country cooperation principles by issuing "Management and Supervision of Cross-Border Electronic Banking Activities."[13]

Before granting consent to the establishment of a cross-border establishment, the home and host authorities should each review their supervisory responsibilities with respect to the establishment. If either of the authorities have any concerns about the division of responsibilities, then that authority has the responsibility to initiate consultations with the other authority so that they reach an explicit understanding on which one of them is in the best position to take primary responsibility, either generally or in respect of specific activities. A similar review should be undertaken by both authorities if there is a significant change in the bank's or banking group's activities or structure.[14]

The home supervisor will need to take account of the fact that capital cannot always easily be moved from one part of a banking group to another across international borders. Host country supervisors are primarily responsible for the liquidity of foreign establishment, since they are better equipped to assess liquidity as a function of local market conditions and practices, although the home country supervisor is responsible for group liquidity.[15] Host country supervisors will also be responsible for the solvency and supervision of subsidiaries, although solvency of the entire group is the responsibility of the home country (see Box 4).

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[11] For the Memoranda of Understanding (MOUs), see Section D.

[12] Basel Committee (2003 c).

[13] Basel Committee (2003 d).

[14] In the case of the member countries of the European Union, the Banking Coordination Directive (2000 L 0012, November 2003) predetermines the home/host country responsibility for supervising bank's various activities.

[15] In some countries, liquidity is increasingly outsourced by the host authorities to home authorities if the bank is operating its liquidity on a global consolidated basis.

Box 3. Essential Elements of a Statement of Cooperation Between Banking Supervisors[1]

The Basel Committee Working Group on Cross-Border Banking prepared the note in May 2001. A number of countries have suggested that there is a need for a statement setting out the essential elements of a MOU or similar document that can be used as a reference for establishing a bilateral relationship between banking supervisory authorities in different countries (and, where appropriate, between banking supervisors and other financial regulators).

The note sets out essential elements in the areas of sharing information, on-site inspections, protection of information, and ongoing coordination.

- **Sharing of information**

In connection with the authorization process, and in accordance with the Core Principles:

(a) The host supervisors should notify the home supervisors, without delay, of applications for approval to establish offices or make acquisitions in the host jurisdiction.
(b) Upon request, the home supervisor should notify the host supervisor whether the applicant bank is in compliance with banking laws and regulations, and whether the bank may be given its administrative structure and internal controls to manage the cross-border establishment in an orderly manner. The home supervisor should also, upon request, assist the host supervisor by verifying or supplementing any information submitted by the applicant bank.
(c) The home supervisor should inform the host supervisor about the nature of the regulatory system and consolidated supervision over the applicant bank. Similarly, the host supervisor should indicate the scope of its supervision and indicate any specific features that might give rise to the need for special arrangements.
(d) To the extent permitted by law, the home and host supervisors should share information on the fitness and properness of prospective directors, managers, and relevant shareholders of the cross-border establishment.

In connection with the ongoing supervision of their cross-border establishments, the supervisors from the host and home country should do the following:

(a) Provide relevant information to their counterpart regarding material developments or supervisory concerns in respect of the operations of a cross-border establishment.
(b) Provide information on their respective regulatory systems and major changes, in particular, those which have a significant bearing on the activities of cross-border establishments.
(c) Inform their counterpart of penalties imposed or enforcement actions taken, against a cross-border establishment.
(d) Facilitate the transmission of any other relevant information that might be required to assist with the supervisory process.

- **On-site inspections**

The statement should recognize that cooperation is particularly useful to the supervisors in assisting each other in carrying out on-site inspections of cross-border establishments in the host country. The home supervisor should notify the host supervisor of plans to examine a cross-border establishment and to indicate the purpose and scope of the visit. The host supervisor should allow the home supervisor or its delegated agent to conduct on-site inspections. As may be mutually agreed between the parties, examinations may be carried out by the home supervisor alone or accompanied by the host supervisor. Following the inspection, an exchange of views should take place between the examination team and the host supervisor.

- **Protection of information**

The statement should recognize that mutual trust between supervisory authorities can only be achieved if exchanges of information can flow with confidence in both directions. The supervisor receiving the information must provide the assurance that all possible steps will be taken to preserve the confidentiality of the information received.

- **Ongoing coordination**

The statement should recognize that visits for information purposes and exchanges of staff may promote cooperation between supervisors.

[1]See Basel Committee on Banking Supervision (2001).

Box 4. Capital and Asset Maintenance Requirement on Foreign Bank Branches

Some countries apply a stringent capital requirement for foreign bank branches. The concerns are twofold: there may be some reluctance to rely on the home country regulations in some cases; and in the event of a failure of a parent bank, there is concern that any resolution might favor depositors and creditors in the home country at the expense of host country. Therefore, some host country supervisors want to rely on foreign bank branches having capital and assets in the host country to match their liabilities in the host country.

Some countries like the United Kingdom have different approaches. For example, the United Kingdom has been neutral about the way in which foreign banks operate in London. In practice, most of the large foreign banks have chosen to operate as branches, perhaps reflecting the nature of their activities within London's wholesale markets, though subsidiaries are also used particularly for specialized activities in the retail market. Many banks operate both branches and subsidiaries. Branches are useful where a bank wants to obtain prime rates either in the interbank deposit markets, the foreign exchange market, or derivative market. If a major international bank cannot use its entire capital base, it is hampered. Moreover, by having to hypothecate capital all over the world, a major international bank loses flexibility, a problem which adds to its costs. The United Kingdom authorities have not, therefore, applied quasi-capital requirements for foreign bank branches. Thus, if a major international bank like the Citibank London branch is involved in a particular transaction, the United Kingdom authorities expect that the deal will be supported by the entire capital of Citibank and not just by the resources that Citibank may have in London at the time. However, the United Kingdom supervisors also have a category of banks from countries where they are not totally confident of the quality of supervision where they will be prepared to license, but only on condition that the bank opens a subsidiary, which can then be supervised on a stand alone basis.

The issue of foreign branches in applying exposure rules is also controversial. Where such countries with low credit ratings have allowed foreign banks to open branches, the authorities have been accused of allowing an unleveled playing field, in that foreign banks do not have to have capital in the host country and are not bound effectively by local large exposure rules. The problem is particularly acute in very small countries. In some circumstances, such countries may have a few large companies, and the local banks cannot compete because the large exposure rules keep them from offering large lines, whereas a small branch of a major international bank can offer these lines using the parent bank's worldwide capital. Many countries have tried to level the playing field by requiring such banks to have some form of quasi-capital and sometimes limit lending to a multiple of that local quasi-capital. This of course ties the foreign bank down and restricts its ability to compete. It is often, however, ineffective because quasi-capital requirements can be met simply by a piece of bookkeeping. Foreign bank branches can try to avoid the requirements by booking some of the transactions at the offshore branches.

According to the Basel Concordat, host authorities are responsible for the foreign bank establishments in their territory, and home-country authorities are responsible for these establishments as parts of larger scale activities of banks under their supervision. Notwithstanding a certain division of responsibilities, home and host supervisory authorities should be in close cooperation.

With regard to the remedial actions against establishment abroad, the home country supervisor can require the management at the head office of branches abroad to remedy deficiencies in the branches and apply the full range of legal instruments against the head office to achieve the result. However, subsidiaries are subject to the jurisdiction of the host country, even though its home supervisor may have some influence to induce improvements.

When a bank that has a branch operating in another country is closed, liquidated, or declared insolvent, the supervisory authority in the country where the branch is established must immediately be informed by the home supervisory authority. The host authority would then promptly close the branch. Unlike branches, bank subsidiaries are legally separate from the parent bank. Their assets and liabilities, in theory, remain unchanged when the parent bank closes. However, there is an increased risk of transferring assets and liabilities between the closed parent and a subsidiary, which could damage the subsidiary's financial position.[16]

B. Consolidated Supervision

In many countries, banks are not stand-alone institutions but are rather a part of holding company groups. It is possible that a holding company can transfer capital, asset, and liability positions among its various entities including foreign subsidiaries, but if these positions are not treated on a consolidated basis, then they may pose considerable risks to a bank in the context of capital adequacy and liquidity. Some concerns are also voiced by complex financial institutions active in a number of jurisdictions. These concerns could easily be increased by asymmetries in information between home and host country supervisors. These potential problems can only be minimized by accounting consolidation and consolidated supervision.

An essential element of banking supervision is the ability of the supervisors to supervise the consolidated banking organization. This includes the ability to review both banking and nonbanking activities conducted by the banking organization, either directly or indirectly (through subsidiaries or affiliates), and activities conducted at both domestic and foreign offices.[17] The recent emergence of financial conglomerates and ongoing development of techniques to supervise these institutions raise unique issues. Certain important aspects of

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[16] International Monetary Fund (1998), pp. 41–51.

[17] See Baldwin and Kourelis (2002) for consolidated supervision issues.

supervision might include matching capital levels to the risk profiles of financial conglomerates, related cross-border insolvency of a group, effective cross-border supervision, and consolidated supervision among other things (see Box 5 for Supervision over a "Group to Which a Bank Belongs").

Basel Core Principle 23 stipulates that banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries.

The corporate structure of a banking group should be transparent to the home and parent-level supervisors so that they are able to supervise the group effectively on a consolidated basis. Concerns are most acute when corporate complexity results not from legitimate business decisions, but on the part of the institution to thwart the supervisor's efforts to oversee its activities.

A home country supervisory authority is responsible for supervising the global operations of a bank or banking group on the basis of consolidated, verified, and prudential information. This approach encompasses not only a bank holding company's or parent bank's direct branches and subsidiaries but also includes any significant nonbank companies and financial affiliates.

The home supervisory authority has a responsibility to safeguard the domestic financial system by preventing the establishment of unsupervised or under-supervised foreign banking establishment in its jurisdiction. If the bank or banking group is not subject to consolidated home supervision, or if the home supervisor does not have the capacity to perform such supervision, the host country authorities should not allow any cross- border establishment of that bank or banking group in its jurisdiction.

Special problems can be posed by so-called shell banks and parallel-owned banks.[18] To be effective, no shell bank and parallel-owned banking structure, in principle, should be licensed

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[18] A shell bank is a bank that has no physical presence (i.e., meaningful mind and management) in a country where it is incorporated and licensed and is not affiliated to any financial services group that is subject to effective consolidated supervision. The mind and management are located in another jurisdiction. A parallel-owned bank can be defined as a bank where a bank in one jurisdiction has the same ownership as a bank in another jurisdiction, although one is not a subsidiary of the other.

Box 5. Supervision of a Group to Which a Bank Belongs

- A financial group incorporating banking, securities, and insurance subsidiaries and other financial intermediaries can be subject to different regulators and regulatory regimes. At the domestic level, this already poses significant problems. These problems are compounded at the international level, where the problem of coordination, information, and compliance potentially involves several regulators for each country in which the conglomerate is operating.

- The technical issues that need to be addressed in the context of international financial conglomerates may consist of the following: (1) the supervision of financial conglomerates on a group-wide perspective; (2) techniques for assessing the capital adequacy of financial conglomerates; (3) the test on "fitness and propriety" of management; (4) a supervisory approach to large exposures and to intra-group exposures within financial conglomerates; and (5) the supervisor's ability to intervene in structures that impair effective supervision.[1]

- Countries need to urgently develop consolidated supervision practices over financial conglomerates. Several agencies, working on the basis of different legal and regulatory regimes in different jurisdictions, may be involved in assessing the risk incurred by cross-sectoral financial conglomerates. Data collection, information exchange across sectors and internationally, as well as analysis tend to be underdeveloped.

- Recently, cooperation across markets to strengthen supervision of financial conglomerates has been enhanced. The Joint Forum on Financial Conglomerates has been working as a principal element of its efforts to enhance cooperation with securities and insurance supervisors so as to strengthen the supervision of financial conglomerates. This forum has also been pursuing practical means to facilitate the exchange of information among supervisors, both domestically and internationally, and has identified legal and other impediments to such exchanges.

- A Task Force of the Joint Forum has been conducting an analysis of 13 international financial conglomerates in order to enhance the understanding of the ways in which such groups are managed and organized. This experience has identified structural, operational, and risk management issues within these conglomerates, and the need to strengthen relationships between supervisors from different countries, a key element in managing banking crises. In the case of parallel-owned banks, where a bank in one jurisdiction is under the same nonbank ownership as a bank in another jurisdiction, the consolidated banking supervision should be applied. If the nonbank owner has the ownership of one or more banks, the owner ought to be subjected to consolidated supervision, notwithstanding the separate responsibility of the supervisory authorities in the respective individual countries. The respective supervisors need to prevent sources of contagion by particularly stringent connected lending rules.[2]

[1] International Monetary Fund (1998), pp. 50–51.

[2] See Miles (2002) for supervision issues related to large complex financial institutions.

because they conflict with the Basel Committee's Core Principles.[19] Furthermore, international AML/CFT standards have called for an explicit elimination of shell banks.[20]

As part of practicing consolidated banking supervision, banking supervisors must adequately monitor and apply appropriate prudential standards to all operations of their banking organizations worldwide, including at their foreign branches, joint ventures, and subsidiaries. A major responsibility of the parent bank supervisor is to determine that the parent bank is providing adequate oversight, not only of its overseas branches, but also its joint ventures and subsidiaries. This parent bank oversight should include monitoring compliance with internal controls, receiving an adequate and regular flow of information, and periodically verifying the information received. See Appendix III for country cases on authority to apply regulations on a consolidated basis to cross-border establishments, joint venture, and associates of domestic banks.

A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, including host country supervisory authorities as indicated in Basel Core Principle 24. This contact should commence at the authorization stage when the host supervisor should seek approval from the home supervisor before issuing license.[21] In many cases, bilateral arrangements exist between supervisors. These arrangements can prove helpful in defining the scope of information to be shared and the conditions under which such sharing would normally be expected.

Home country supervisors have the right to gather information from their cross-border banking establishments. In order for home country supervisors to practice consolidated supervision effectively, the host country supervisor must share information about the local operations of foreign banks. Host authorities also should be able to obtain any necessary information from the home authority. This ability to gather information should be a condition for giving consent for the cross-border establishment of a bank.

The information to be shared should encompass both qualitative and quantitative aspects. The information should permit the supervisors to calculate the bank's (or banking group's) capital adequacy ratios, large exposures or legal lending limits, and funding and deposit concentrations on a consolidated basis. However, home and host authorities need to

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[19] International Monetary Fund (1998), p. 173, and Basel Committee on Banking Supervision (2003 a, b).

[20] See Recommendation 18 of the Financial Action Task Force on Money Laundering.

[21] The prior consent of the home country supervisor should be obtained for booking branches, so that the home country supervisor is aware of the existence of the booking branch and is able to confirm that it will include the branch in its consolidated supervision.

acknowledge that prudential standards and supervisory practices may differ between countries.

Authorities of the host state should permit on-site inspections by the home supervisor of a prudential nature of establishments of internationally active banks within its jurisdictions. Together with the free flow of data, such inspections are a necessary corollary of effective consolidated supervision. To conduct on-site inspections in the territory of another state requires the consent of the country receiving the inspection team. Any legal barrier against such on-site inspections would need to be removed, for instance, by concluding agreements between countries on the conduct of such inspections. See Appendix IV and V for country cases on authority to have contacts and exchange supervisor information with, and allow on-site inspection by, foreign financial supervisory agencies.

C. Quality of Home-Country Supervision

Difficulties at the parent bank could raise questions about the fortunes of the local affiliate, even if its position is fundamentally sound. Since difficulties at a parent bank could quickly create doubts about the viability of local branches or subsidiaries, the capabilities of home country supervisors to perform effective supervision is crucial.

A host state should be able to ascertain whether the home state can "capably perform home country consolidated supervision" as a condition for permitting a foreign bank entry to its territory.[22] If a host supervisory authority is in any doubt in this respect, it should either refuse entry or stipulate that the establishment shall be supervised on a strict independent basis.

The quantity and quality of available resources to supervise the foreign operations of a home country should be assessed, as well as its supervisory techniques, frequency of inspections, and any other similar methods of supervision. These items should provide the basis for a judgment as to whether the home supervisory authority is capable of performing consolidated supervision. It is also important to establish the track record of the home supervisory authority in taking effective supervisory action against banks, especially those with overseas subsidiaries or branches. To facilitate this process, a system of routine personal contacts should be developed between supervisors of the host and home countries.[23]

In the case of the U.S. banking supervisory authorities, the review of home country supervision quality has been strengthened since 1991. The Foreign Bank Supervision

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[22] See Basel Core Principle 23 (Global Consolidation).

[23] See Basel Core Principle 24 (Information Exchange with Host Country Supervision).

Enhancement Act (FBSEA) of 1991 gave the Federal Reserve System (FRS) enhanced supervisory and regulatory authority over foreign banks operating in the United States.[24]

Since 1992, the FRS has only been able to approve an application from a foreign bank to establish an office in the United States if it is able to conclude that the bank is subject to comprehensive consolidated supervision by its home country supervisor.[25] In 1996, the Congress amended the regulations regarding comprehensive consolidated supervision to allow somewhat more flexibility. The FRS has the authority to close or restrict the activities of existing branches and agencies if consolidated supervision is missing, it but has not yet considered it necessary to exercise this power.

In keeping with its enhanced authority, the FRS has worked with other supervisory agencies to develop the Foreign Banking Organization Supervision Program. This program focuses on incorporating into supervisory procedures a common understanding of a given foreign bank in its entirety, including policies and practices in the foreign bank's home country, as well as the overall condition of the foreign banking organizations combined in U.S. operations.[26]

The program calls for coordinated development and common use of five new products. Two of these programs are referred to as "country reports." One country report is to provide information about the financial system and supervisory and government policies in the foreign bank's home country, and the other is to provide information about significant accounting policies and practices in the home country.

A third product, the Strength-of-Support Assessment (SOSA), to be based on the country reports and other financial data, will provide analysis and a ranking to reflect the U.S. supervisors' judgment about the foreign banking organization's ability to provide its U.S. operations necessary financial and managerial support. These assessments are to be used along with other information for reaching decisions regarding the scope and frequency of exams and for other supervisory and enforcement matters.

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[24] Before FBSEA, each such office was examined by a federal or state supervisor and treated as a separate entity if the foreign banking organization had multiple offices in the United States.

[25] Supervision on foreign banking organization is subject to various other U.S. regulators such as the Office of the Comptroller of Currency (OCC), Federal Deposit Insurance Corporation (FDIC), and state regulators depending on the types of the foreign banking organization.

[26] The FRS does not necessarily conduct on-site examinations of the entire foreign banks.

A fourth product, the Summary of Condition and Combined Rating, is designed to provide the management of foreign banking organizations and U.S. supervisors with an overall assessment of the their U.S. operations. The last new supervisory product is an annual comprehensive examination plan. This examination plan is to be developed from information in the SOSA, the results of individual prior examinations, and the overall assessment of the foreign bank's combined U.S. operations.[27]

D. Memoranda of Understanding With Home-Country Supervisors

A critical component of consolidated supervision is establishing contact and information exchange with various other supervisors involved, including host country supervisory authorities. This contact should commence at the authorization stage when the host supervisor seeks the approval from the home supervisor before issuing a license. In many cases, bilateral arrangements between supervisors can prove helpful in defining the scope of information to be shared and the conditions under which such sharing would normally be expected. A number of countries have concluded a bilateral exchange of letters of signed Memoranda of Understanding (MOUs). As indicated in Box 3**,** "Essential Elements of a Statement of Cooperation between Banking Supervisors" set out key ingredients of MOUs between countries.

MOUs facilitate supervision by setting out the commonly agreed upon terms of understanding between countries and clarifying in advance any assumptions and procedures. MOUs do not set limits on the relationships and interaction between supervisory authorities. They are neither legal documents, nor should any exchange or procedure be prevented because the MOU did not discuss the topic nor because it defined a procedure in a detailed manner. Although there is a high degree of commonality between MOUs, notwithstanding the differences that reflect national discretion and diversity, there is no single model for an MOU. Over time, changing circumstances, for example, an increase of cross-border alliances in banking, may mean that supervisory interaction develops ahead of the texts of the MOUs.

In practice, bilateral arrangements can include such issues as establishment of a branch/notification, exchange of information, inspection, and remedial or punitive actions against cross-border establishments by home and host authorities. In an MOU, operational aspects of cross-border inspections would typically need to be agreed upon in advance by both authorities. The findings of inspections should be shared between the supervisory authorities of both countries as well as with the institutions involved.

When inspections or other information would indicate the need for remedial or punitive action, this may be complicated by differences in legal arrangements. Supervisory authorities

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[27] The FRS Supervision and Regulation Letter SR 00-14 (2000), and the General Accounting Office (1997), pp. 1–2.

in different countries, therefore, conclude arrangements in the MOU to make supervisory action in the foreign state possible, if the need should arise. These arrangements could also include providing assistance in accessing local nonsupervisory information, for example, on the legal system on shareholder's activities.

With the implementation of the Second Banking Coordination Directive of the European Union (EU), many member countries of the EU began to negotiate MOUs in order to facilitate supervisory cooperation in the context of changed supervisory responsibilities brought about by the Directives.[28] Although not all member countries of the EU have signed a full set of MOUs, the work is almost complete, and where agreements have not been concluded, this means a lack of cross-border establishments between member countries. For example, the United Kingdom and the Finnish authorities concluded an MOU in 1994, while the Dutch and Finnish authorities agreed on an MOU in 1996. On the other hand, although Iceland has signed MOUs with Denmark, Finland, Norway, and Sweden, no cross-border establishments existed in Iceland as of July 2002.[29]

In the case of the Slovak Republic, the National Bank of Slovakia signed the Agreement on Banking Supervision with the Czech Republic, Germany, and Hungary as of end-June 2002. In the case of Estonia, the Bank of Estonia was preparing a series of MOUs with several foreign bank supervisory authorities in 1998. They had signed an MOU with Finland in 1995 and had finalized MOUs with Latvia and Russia in 1999. In the case of Albania, the Governors of the Bank of Albania and the Bank of Greece entered into an agreement for "Cooperative Banking Supervision" with reference to branches of Greek banks operating in Albania. The Finnish Financial Supervision Authority had signed MOUs concerning the supervision of financial institutions with twelve countries as of March 2004. Recently, the Financial Supervisory Commission (FSC) and Financial Supervisory Service (FSS) of Korea have begun entering into MOUs with foreign supervisory authorities to promote consolidated supervision. In the banking supervision areas, FSC/FSS has signed with the following supervisory authorities: Financial Services Authority of the United Kingdom (1999), Financial Supervisory Agency of Japan (2001), Federal Banking Supervisory Office of Germany (2001), France, Vietnam, and China as of February 2004.

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[28] Because the Banking Coordination Directive already establishes the requirements of information exchange, intra-EU MOUs are not legally required. However, the MOUs are used to reinforce the legislative requirements on supervisory cooperation and understanding of how information exchange will take place.

[29] Nevertheless, it is known that the United Kingdom considered that MOUs are not a legal necessity. Therefore, it has no further plans to sign new MOUs with accession countries, although other EU member countries have not taken this view.

E. Ring Fencing of Banks

Recently, a number of banking groups seem to utilize "ring-fencing" arrangements, although international best practices do not exist for these arrangements. Supervisors should be aware of ring-fencing arrangements and their implications in the cross-border supervision.

"Ring-fencing" involves isolating the bank from other companies in the group by taking several actions, for instance: (i) prohibiting or placing severe limits on the financial exposure of the bank vis-à-vis other companies in the group; (ii) restricting the volume of funding the bank receives from companies in the group; and (iii) ensuring that directors and management of the bank can operate the bank independently of the group management. Such precautionary measures could be welcome by supervisors in cases where they have serious concerns about a bank's owners or its positions with a group, although ring-fencing is not established as an international best practice. Ring-fencing could be used in the case of a bank that is part of a mixed activity group but remains essential in the case of a bank that, for example, is a subsidiary of a bank or a branch of a bank incorporated in a country where the bank supervisors do not practice effective consolidated supervision.

Risks carried by local offices may have limited implications for internationally active banks if they are separate legal entities and ring-fenced from the parent group. As a subsidiary being a legally distinct entity from the parent, in case of a subsidiary, the parent's losses in a subsidiary would be, in principle, no larger than its equity stake. On the other hand, in the case of a branch, the parent is not typically legally distinct from the branch so that branch closure may not shield the parent from losses.[30]

In certain instances, ring-fencing can also affect the obligations of the local branches of major international banks. In Asia, some banks, which were "ring-fenced," argue that the imposition on capital outflow could limit the ability of their branches to make payments on foreign exchange-related transactions. In some derivative products, various parent banks inserted the ring-fencing clauses into their confirmation documentation to specify the conditions under which the parent would not be responsible for the payments of the onshore branch and to make the pricing of a transaction more transparent.

Other banks have argued that ring-fencing is not just a pricing issue but has broader systemic implications because it will alter the degree of support that parent banks will offer their on shore branches and subsidiaries during crisis periods.

In some cases, other obligations are ring-fenced by law. For example, under the Federal Reserve Act and also the New York Banking Law, all deposit liabilities of foreign branches of U.S. banks are already ring-fenced, if the local authorities take actions that prevent the

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[30] Bank of England (June 2002) p. 59.

local branch from making payment (such as the imposition of capital controls).[31] The issue may be more complex where these are de facto ring-fencing restrictions that make deposits payable only at the local branches and not at branches in other countries. A number of banking groups seem to apply restrictions of this nature.[32]

This ring-fencing practice could raise some concerns related to transparency in the current system. There is the issue of whether market participants are fully aware of the nature of the ring-fencing contracts. In addition, markets could operate in a very different way during crisis periods due to these ring-fencing contracts. Supervisors should also be aware of some concerns related these contracts.

III. Challenges to Emerging Market Banking Supervisors

The growing presence of foreign banks in many emerging markets has increased the complexity of the tasks facing supervisory authorities. As the presence of foreign banks increases, the domestic supervisory authorities are more likely to upgrade the quality and increase the size of their staff, in order to supervise the more sophisticated activities and new products that are usually introduced by foreign banks. This effect has been observed, for example, in Brazil and Hungary. Before they gain sufficient skills, however, supervisors may have some difficulties in supervising highly sophisticated foreign bank operations, not knowing how to deal with sophisticated operations. This is a particular concern in the cases where foreign commercial banks expand their operations rapidly in the area of nonbank financial services, such as insurance, portfolio management, and investment banking.[33] Given the complex structure of many internationally active banks, it is also a challenge to supervisors to know how to improve governance structure of these banking institutions. Good internal governance may have a better chance of providing early warning signals than would external supervisors on their own, helping to manage operational and reputational risks. Integral issues within foreign banks are increasingly being shown to be of potential systemic significance. These policy issues include cross-border supervision and regulation on a consolidated basis, banking system concentrations and systemic risks, and governance of foreign banking institutions and integrity of financial market among other things.

One of the first problems facing bank supervisors is the issue of licensing policy for foreign banks. Domestic supervisory authorities in emerging economies often have strong views on their choice of licensing policy for foreign banks. Many Asian supervisory authorities note that branches have the advantage of being backed by the full strength of their parent

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[31] International Monetary Fund (2000), pp. 176–77 and pp. 191–92.

[32] Bank of England (June 2002) p. 59.

[33] Hawkins and Mihaljek (2001), p. 29.

institution. They also point out that, under the proposed Basel Capital Accord II, branches of banks incorporated in less risky countries will be able to obtain less expensive funds because they will be subject to lower capital weights, whereas subsidiaries will be covered by the ratings of their host country. Countries that favor subsidiaries stress their ability to better regulate, supervise, and ring-fence subsidiaries in periods of distress. There are some arguments that branches are more difficult to sell to third parties when problems arise.[34] [35] In emerging countries, the licensing policy for foreign banks is subject to political considerations. Political interference in the licensing process of foreign banks could appear on the basis of wider inter-governmental agreement rather than on strict prudential criteria. Procedures should be put into place to shield supervisory decisions on licensing foreign banks from political influence or interference. The supervisory authorities in emerging countries should not unnecessarily delay the approval of foreign bank entry into new markets or products, in order to allow domestic banks sufficient time to gain a foothold in such new activities. The supervisors in emerging markets might have some difficulties in implementing effectively fitness and propriety test of management and owners of foreign banks, especially in case where owners come from a complex holding company or investment funds for which home supervisors are ambiguous.

The second problem facing supervisors in emerging markets is the issue of how to monitor the local establishments of large international banks. These supervisors need to know the financial positions of not only the local branches or a subsidiary of major international banks but also the parent bank. Indeed, difficulties at the parent bank could raise questions about the fortunes of the local affiliate, even if its position is fundamentally sound. Since difficulties at one of these parent banks could quickly create doubts about the viability of local branches or subsidiaries, the stability of emerging market financial systems has become increasingly dependent on the qualities of prudential supervision in mature markets. Nevertheless, emerging markets' supervisors will still need to develop the expertise to monitor a new range of activities and instruments that are likely to be used by the local establishment of large complex banking organizations.[36]

The third issue confronting supervisors is that foreign banks entering local markets tend to offer a variety of new financial products, including derivatives, in order to expand their

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[34] Hawkins and Mihaljek (2001), p. 29.

[35] For example, several years ago, Botswana successfully sold one foreign bank subsidiary whose parent bank had experienced a crisis. Botswana had a BCCI subsidiary that was in itself solvent with a good clientele base even though the parent bank had a crisis in 1991. One banking applicant bought the Botswana subsidiary after some due diligence, although its main concern of course was the global reputation of BCCI.

[36] Mathieson and Roldos (2001), pp. 29–30.

market share in the local market.[37] These new derivative products can allow market participants far better hedging opportunities and, thereby, can be a source of considerable benefit. However, they can also be used as a way of avoiding prudential regulations. Derivatives have also been used to take on what have proven to be excessive risks, especially in weak financial and accounting systems. The emergence of financial conglomerates that provide a wide range of products and services also complicates prudential supervision and regulation. Therefore, it is evident that, as foreign banks enter emerging markets, supervisors need to upgrade their capacity to acquire information on the growing use of financial products, including derivatives and to be able to analyze their implications. In addition, the host country supervisors should have closer contact with the home supervisors because control of derivatives are usually conducted by the home country supervisors. The presence of financial conglomerates could also raise the issue of how the regulatory agencies overseeing banks, securities, and insurance companies should be structured.[38]

The fourth issue supervisors need to be familiar with is to have an understanding of when and to what extent parent-banking organizations will support their local operations in terms of difficulties or crisis. A number of factors are likely to influence both the likelihood and extent of a parent bank's support for its foreign establishment. Both legal and reputational issues are involved in determining the parent bank's support. In the case of a crisis situation, the parent central bank/supervisor support for various elements of dealing with crisis could be needed in addition to the need for close information sharing between authorities.

From a narrow legal perspective, a bank subsidiary is a stand-alone entity with its own capital, and the parent's formal obligation to support its subsidiary is generally limited to the amount of invested capital.[39] Legally, the parent bank may have an option to sell off or close down an insolvent or illiquid subsidiary. However, reputational or strategic issues may be considered in the case of reputable international banks in dealing with any loss-making

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[37] The supervisory authorities in emerging markets should take care not to unwittingly release proprietary information regarding new products or services gained through supervision of foreign banks to the local market.

[38] See Mathieson and Roldos (2001), pp. 30–31 for further discussions of the issue.

[39] To ensure that the parent institution stands behind a subsidiary, host country supervisors often ask parent banks (and sometimes parent country supervisors) to provide comfort letters. However, in most jurisdictions, comfort letters are not the equivalent of guarantees in terms of enforceability. Supervisors should be wary of the risks related to subsidiaries in difficulties in the licensing process and also through the ongoing supervision. For more discussions related to this issue, refer to Hawkins and Mihaljek (2001) pp. 29–30, and BIS (2002) pp. 39–40.

subsidiaries.[40] In contrast, a branch has no independent legal personality distinct from that of its parent, and claims on branches actually constitute claims on the parent. From a supervisory perspective, foreign bank branches have some advantages. They are less likely to engage in connected lending; they are subject to additional oversight by foreign supervisors on a consolidated basis; and they may be subject to more rigorous accounting, disclosure, and reporting requirements.[41]

Other factors also influence both the likelihood and extent of a parent bank's support for its foreign establishment. A parent bank which experiences weak profitability and capital position may have little capacity to recapitalize a large, troubled foreign subsidiary. While the parent bank will typically have a strong incentive to remedy problems created by weak internal controls, it may have a much smaller incentive to support its local establishment if force majeure events prevent the local entity from making payments. It is also evident from recent episodes of ring-fencing of the local branches of some international banks in Asia that there are clear limits on the extent of parental support for these local operations and their obligations.[42]

The fifth issue relates to country cases, where the majority of the banking market is dependent on foreign banks, the supervisory authority tends to face different kinds of challenges. If almost all of the major banks are supervised on a consolidated basis by home supervisors, host supervisors should ensure that the home supervisors are aware of the risks and take them into account for supervision. Under this situation, increasingly, managers responsible for systems or controls of foreign banks may not be available in the host supervisors because the functions are usually centralized in the home country with the modern technology. There always exist political barriers to exchange information between home and host supervisors. Legal and tax issues could be involved and, sometimes, MOUs are regarded as of little practical help. Under these situations, foreign banks tend to behave like branches, even where they entered as subsidiaries. However, under this situation, branches are best for host supervisors since a foreign bank is less likely to walk away from a branch than from a subsidiary.

The supervisory authority could also face challenges in a situation where the systemic importance of subsidiaries/branches of banks from specific countries at regional levels exist, for example, Spanish banks in Latin America, French banks in West Africa, and Australian banks in New Zealand. If the operations are all foreign controlled, the host supervisors are relegated to "secondary" supervisors since some of the risk-management responsibilities is

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[40] See Box 1 in Appendix I for some discussions regarding the recent Argentine case.

[41] Hawkins and Mihaljek (2001), p. 29.

[42] International Monetary Fund (2000), p. 176 and Mathieson and Roldos (2001), p. 31.

taken away from domestic management. There is a need for greater coordination with the home supervisor, particularly on crisis management issues.

The sixth problem confronting supervisors in the emerging markets is that of systemic risk associated with cross-border banking. Systemic risk potentially can either increase or decrease as a result of a growing foreign presence in the banking system. If a foreign bank entry leads to consolidation in the banking system and contributes to create a more efficient, smaller set of larger institutions, this may reduce systemic risks. A diversified portfolio of foreign banks can also reduce systemic risks. However, failure of large institutions can be a source of more severe systemic risks. Weakened parent banks could quickly worsen the liquidity situation of local subsidiaries and, thereby, diminish stability in the local market.[43]

A seventh difficulty that supervisors must be aware of in many emerging markets is that many banks are not necessarily stand-alone institutions but are rather part of a holding company group. Even when banks are of a relatively modest size, the existence of these groups raises issues about what level of consolidation should occur when evaluating bank capital adequacy or liquidity. It is possible that a holding company can transfer capital, asset, and liability positions among its various entities, but if these positions are not treated on a consolidated basis, they may pose considerable risk to a bank in the context of capital adequacy and liquidity. Distorting capital and liquidity requirements could lead to misrepresenting holding company financial positions and, thereby, the risk of abuse of financial markets could increase. On the other hand, support to the bank holding company during a period of crisis period will either directly or indirectly assist the rest of the group. These potential problems can only be minimized by consolidated supervision at the group level. In addition, the host country supervisors should ensure which supervisory authority is the main home supervisor for a holding company group. In a crisis situation, problems could be aggravated in case it is not certain who is the main supervisor for the holding company group in the home country. The appropriate prudential supervision and enhanced mechanism for preventing money laundering and terrorism financing should also be incorporated to prevent potential problems associated with the entry of a foreign bank as a part of the holding group.[44]

Some concerns are voiced over the multiple challenges to supervision raised by complex financial institutions active in a number of jurisdictions. These concerns could easily be increased by imbalances in information between home and host country supervisors. Even among those who support increased foreign ownership, many argue that the degree and sequencing of such openness to foreign banks is critical, and that it should follow the consolidation and strengthening of the domestic financial system and the development of

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[43] International Monetary Fund (2000), p. 192.

[44] International Monetary Fund (2000), p. 193.

necessary financial infrastructure, including supervision.[45] In addition, bank supervisors should be aware of the importance of good corporate governance of these complex financial institutions as well as the main supervisor of them.

Finally, the entry of foreign banks can increase concentration within the banking system, both on the international and domestic fronts. In some countries, such as Chile, this issue arose when the parent institutions of two local banks merged. The entry of foreign banks can also create pressures on local banks to merge to remain competitive. The process of financial sector consolidation in emerging markets raises a number of policy issues, including how to create sufficient market discipline and official supervision for institutions that are “too big to fail.” Supervisors should be prepared for the possibility of increasing concentration in the local banking industry, spurred by the expansion of large international banks into the local market.[46] There are concerns that such concentration could create monopoly power that would reduce banking system efficiency. If governments are more likely to protect large banks because they are regarded as “too big to fail,” then mergers stimulated by foreign bank entry could increase the implicit costs associated with maintaining the official safety net.

Integrated operations of consolidated financial institutions possibly imply increased operational risks. Integration reduces transparency and increases the potential for risk management errors. Integration also tends to make the risks of consolidated institutions harder for supervisors to measure, since risk transfer techniques become more complex and create new interdependencies in group risk profiles. These same risk transfer techniques could also increase the risk of abuse of financial markets. Moreover, consolidation can considerably complicate the resolution of an institution in the event of insolvency. The complexity of unwinding an integrated risk management strategy increases the risk that the resolution process could become disorderly. This is clearly the case for larger institutions that are more dependent on risk transfer markets, including interbank and derivative markets, especially when an institution is large enough to be systematically significant. Transnational consolidations increase the complexity of handling a distressed firm since multiple regulatory authorities and differing national safety net provisions must be reconciled. Cross-border consolidation can increase the potential for systemic problems in one financial system to spill over into another.[47] Dealing with these problems will involve strengthening prudential supervisory capacity to monitor activities of large complex financial institutions and establishing clear entry and exit rules and prompt corrective action for distressed institutions.

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[45] Goldberg, Dages, and Kinney (2000), p. 5.

[46] International Monetary Fund (2000), pp. 173–74.

[47] Group of Ten (2001), Report on Consolidation in the Financial Sector.

IV. CONCLUSION

As the presence of foreign-owned banks grows, the complexity of the tasks facing supervisory authorities increases. The challenges for emerging market supervisors include: (i) choosing of licensing policy and fitness and propriety test for management and owners of a complex holding company or investment funds; (ii) effectively monitoring the local establishment of large international banks or complex financial institutions; (iii) upgrading their supervisory capacity to oversee complicated financial products of foreign banks; (iv) dealing with the issue of the parent bank support in case of difficulties of a branch or subsidiary in normal as well as systemic crisis situations; (v) handling consolidated supervision in the event the market is heavily dependent on foreign banks; (vi) effectively exchanging information with the home supervisors in the case of bank holding companies or other complex financial institutions; (vii) dealing with increasing concentration in the banking system by foreign banks; and (viii) improving the governance structure of complex international banking groups while, among other things enhancing the integrity standards in the financial markets. These challenges should be resolved through more enhanced cooperation between home-and host-country supervisory authorities, as well as development of additional international best practices.

I. The Pros and Cons of Licensing Foreign Banks

A. Arguments for Foreign Bank Entry

Increasing and diversifying available funds

The presence of foreign banks is generally agreed to increase the amount of funding available for domestic projects by facilitating capital inflows. Foreign banks are often better equipped and more experienced than local banks in the handling of international finance and financial instruments which require an international network.

Foreign bank presence may contribute to the stability of available lending by diversifying the capital and funding bases. In all but a few countries, domestic banks have difficulty in diversifying because their lending is concentrated in the home country. In contrast, foreign banks tend to have more diversified portfolios and also usually have access to sources of funds from all over the world through their branching network.[48] This diversification contributes to economies of scale and scope in the domestic market.

The countries experiencing a banking crisis regularly turn to foreign banks to help rebuild and restructure the domestic banking system.[49] In the wake of financial crises, foreign institutions may represent important sources of equity capital for domestic financial systems, especially in post-crisis recapitalization efforts.[50] The scale of banking problems in the mid-1990s in Mexico and Venezuela, and to a lesser degree in Brazil, created incentives to allow greater foreign bank entry to rebuild capital of distressed banks.[51] After the Asian crisis, foreign bank participation in the Asian market also increased considerably.

Enhancing banking market competition and efficiency

It is frequently asserted that foreign bank entry renders national banking markets more competitive and, thereby, can force domestic banks to start operating more efficiently. Foreign banks may well introduce competitive pressures that would benefit both savers and lenders.

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[48] Mishkin (2001), pp. 26–27.

[49] Mathieson and Roldos (2001), pp. 10–11.

[50] Goldberg, Dages, and Kinney (2000), pp. 3–4.

[51] International Monetary Fund (2000), p. 160.

Therefore, foreign banks can make significant contributions to the production and service innovation in developing countries by introducing modern, sophisticated techniques and banking practices, training nationals, and using extensive market analysis for clients and for other banks more quickly than would be developed by indigenous bankers.

Empirical evidence shows that greater foreign bank ownership indeed reduces the profitability and overall expenses of domestically owned banks. These results suggest that foreign bank entry leads to greater efficiency in the functioning of national banking markets, with positive welfare implications for banking customers. The relaxation of restrictions on foreign bank entry may similarly reduce domestic banking profits and force domestic banks to cut costs, but with positive overall welfare implications for the domestic economy.[52]

The findings of increased domestic bank efficiency, at least as measured through local profit margins, also are supported by a case study done by Goldberg, Dages, and Kinney (2000) of the Argentina experience in the mid-1990s. Foreign bank entry was found to focus on specific lending areas that reflected foreign banks' perceived comparative advantage, most notably, in lending to manufacturing and utility sectors (and much less so to retail customers). However, increased foreign competition in corporate loan markets reduced associated net margins and before-tax profits; margins and profits remained higher in the consumer sector that had not attracted comparable foreign banks.[53]

On the other hand, empirical findings based on the Philippines' case illustrate that no strong improvement in domestic bank efficiency in deposit or loan production occurred after foreign bank entry was liberalized in 1994. It is argued that the modest improvements in banking efficiency in 1996 suggest that the liberalization of foreign bank entry was too restrictive to generate a competitive environment. The liberalization of foreign bank entry can prevent the deterioration in banking efficiency, but only if entry is sufficiently large.[54]

Developing financial markets and market infrastructure

The entry of foreign banks will assist in the development of financial markets. For example, foreign banks that lack a branch network to guarantee deposit financing of their activities are more likely to turn to the interbank market. Foreign banks can also contribute to bringing professional expertise to the local foreign currency markets. Foreign bank branches are sometimes willing to undertake the obligations of "market makers" if they are authorized as

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[52] Claessens, Demirgüç-Kunt, and Huizinga(1998), p. 18.

[53] Goldberg, Dages, and Kinney (2000), pp. 3–4.

[54] Montinola, Gabriella and Ramon Moreno (2001).

foreign exchange dealers. They can contribute to both the level of competition and professional expertise of the market.

Entry of foreign banks can encourage adoption of best practices in the banking industry and could improve the underlying bank supervisory and legal framework. Foreign bank entry could have a positive affect on the domestic banking sector by triggering a strengthening of prudential regulations, such as provisioning regulations affecting all banks. Foreign bank presence may also serve to import financial system supervision and supervisory skills from home country regulators. While many of these goals may ultimately be achievable without foreign financial institutions, increased foreign presence may meaningfully accelerate the process.[55]

B. Arguments Against Foreign Bank Entry

Weakening infant domestic banks

The main argument against an early market entry of foreign banks is the risk that domestic financial institutions would not be able to withstand increased competitive pressure and might even risk facing bankruptcy. Such banking failures might have spillover effects on other banks and could possibly endanger stability in the financial market.

If domestic banks fall under the "too big to fail" category and thus require some support, suppressing competition from new entrants can be an inexpensive form of support. Restricting bank entry is a way of providing a hidden subsidy to the existing industry and temporarily avoiding the costs of restructuring the financial sector. Such delays also bear a social cost, since inefficient banks will continue to misallocate resources.

Serving only the "best" customers

There exist some pros and cons relating to serving only the "best" customers. An argument which is often voiced against the market entry of foreign banks is the fear that foreign banks choose only the "best" clients, leaving the domestic banking sector with a pool of low-return and high-risk enterprises. Foreign banks may emphasize lending for foreign trade and to large domestic companies with a foreign reputation or wealthy individuals. They are likely to have little interest or expertise in dealing with smaller domestic companies which may not satisfy international accounting standards.

The fact that foreign banks tend to operate with clients, which ex post are revealed to have an above average profitability, could imply that foreign banks have developed better risk assessment techniques than the domestic banks. Foreign banks, in many cases, merely follow their clients abroad and, thus, expand their home country business and could suggest that this

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[55] Goldberg, Linda, Dages, and Kinney (2000), pp. 3–4.

type of business may not be available to the domestic banks. Foreign banks make use of the specific customer relationships that they have built up which cannot easily be replicated by a domestic bank.[56] Unfortunately, the threat of foreign banks drawing more profitable business from incumbent local banks might, in fact, force local banks to make necessary reforms.[57] [58]

Likelihood of bringing instability

It is argued that the presence of foreign banks may not necessarily yield a more stable source of credit to domestic borrowers because foreign banks can, at times, shift funds abruptly from one market to another for risk management purposes.[59] There are many examples of foreign banks that have withdrawn from markets after unprofitable operations.[60] Growing presence of foreign banks could open up a new channel for the transmission of disturbances from the mature to emerging market, as suggested in the experience of Baltic States—Estonia, Latvia, and Lithuania. Moreover, in case its lending operations were highly exposed to its home country, then a business-cycle induced downturn in home country could reasonably be expected to affect more negatively its subsidiaries in overseas countries.[61]

It is argued that foreign banks will be more likely to shift their funds to more attractive markets during a crisis if their parents are weak. There are two related issues here: (i) whether the presence of foreign banks makes systemic banking crises more or less likely to occur, for example, by providing an additional avenue for capital flight, and (ii) whether there is a tendency for foreign banks to "cut and run" during a crisis. On the other hand, foreign banks can contribute to the stability of the domestic financial system, for example, if depositors shift their deposits to foreign banks from their risky local banks rather than engaging in a capital flight.[62]

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[56] Bush (1996), pp. 12–13.

[57] See Graham (2001).

[58] Sometimes domestic versus foreign ownership presents a quandary. For instance, in Africa a number of banking crises have been the results of indigenous banks that were established to serve their owners and to take away the privilege of foreign banks profiting from non-home ground.

[59] International Monetary Fund (2000), p. 158.

[60] International Monetary Fund (2000), p. 191.

[61] For more information on foreign bank ownership in the Baltic States, see IMF (2004), pp. 25–28.

[62] International Monetary Fund (2000), p. 170.

There is also a need to distinguish between normal times and extreme macro crisis regarding making up for losses of subsidiaries by the parent banks. It would be safe to assume that parent banks have a legal obligation to take responsibilities for losses of overseas branches. They will also typically revamp losses of subsidiaries in consideration of reputation risks or strategic reasons. However, it could become a substantially different matter under severe macroeconomic disturbances like in the recent Argentina case (See Box 1).

Box A1. Argentina Case

In Argentina, foreign-owned banks accounted for well over one-half of banking system assets and liabilities as of end-2001. The Argentine government debt default, the sharp devaluation of the peso, and uncertainties concerning the status of deposit and the loan contract quickly pushed Argentina's banking system to a verge of collapsing. Since December 2001, the Argentine authorities have declared a moratorium on payments on their public debts, abandoned the currency board, and determined that dollar-denominated loans and deposits would be exchanged into pesos at different rates (1:1 and 1:1.4, respectively). These and other policy responses created large losses in the Argentine banking system within a short period of time. As a result, a number of internationally active banks have sustained substantial losses.

Because the host authorities might be fiscally unable to bailout a large foreign bank subsidiary, they might well pressure the parent to invest new funds to recapitalize the subsidiary. However, under these circumstances, some parent banks have decided not to recapitalize their local subsidiaries. It would be quite difficult to expect a parent bank to cover such losses resulting from the host government's own policy actions that led to the insolvency of the banking system, and where problems are compounded by a series of other deliberate policy measures.[1] In addition, the foreign bank might wish to avoid having a dominant position in any particular country, since a refusal to recapitalize the bank would be seen as extremely damaging to the country concerned.[2]

[1] Bank of England (2002) p. 59.

[2] The Bank for International Settlements (2002) pp. 57–58.

Although there are few empirical studies, the results are mixed. Levine (1999) concluded that greater foreign bank participation was a stabilizing factor in a crisis situation.[63] In contrast, in their empirical studies on the links between foreign banks and stability in emerging market-banking system, Mathieson and Roldos (2001) draw no firm conclusion on whether foreign banks provide emerging market banking sectors more stability and lessen credit volatility.[64] With regard to the foreign banks' lending tendency in a crisis situation, some empirical studies argue that a bank's soundness and not ownership, as such, is the critical element in the growth and volatility of bank credit.[65]

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[63] Levine (1999), and Graham (2001), p. 17.

[64] Mathieson and Roldos(2001), pp. 12–17.

[65] International Monetary Fund (2000), pp. 168–69.

II. Country Cases on Whether Permission of Foreign Supervisor is Required in Licensing Foreign Bank Branches or Subsidiaries

Australia	Yes. Foreign bank applicants must have a consent from the home supervisor for the establishment of banking operations in Australia.
Bahamas	Yes. The foreign supervisory authority must make no objection to the establishment of a branch or subsidiary in the Bahamas. In addition, the governor must be satisfied that the bank or trust company is subject to adequate consolidated supervision.
Bahrain	Yes. Evidence that the parent supervisory and regulatory authority for the applicant or its holding company have no objection to the grant of a license is required as part of the licensing process. The Bahrain Monetary Authority (BMA) will refer directly to relevant overseas authorities in reviewing license documentation.
Bulgaria	Yes. The written approval of the bank supervisory body of the country of domicile is required for opening a bank branch. A license shall be issued solely to prime rate banks operating in international financial markets or to banks having guarantees by such banks.
Canada	Yes. The Office of the Superintendent of Financial Institutions (OSFI) requires a statement from the home supervisor of the foreign bank that the supervisor is aware of the intention of the applicant to incorporate a bank subsidiary in Canada, and that the applicant is in good standing in the home country. In the case of a branch, the OSFI sets out the requirements regarding the home country supervisor, which includes a statement from the home supervisor that it does not object to OSFI and that the regulator would not object to the OSFI visiting the applicant to discuss the foreign bank's operations and/or its Canadian branch operations. Regarding a representative office, foreign bank's application shall include a statement from the home regulator that the foreign bank is in good standing.
Cayman Islands	As part of an application for a license, the applicant shall submit a statement in writing in a form acceptable to the inspector from the authority responsible for the supervision of such businesses in the country in which the applicant or its parent company is incorporated.
Cyprus	If the applicant for a banking license is a nonresident, then the home country's supervisory authority's consent is required.
Czech Republic	Yes. Before issuing a decision concerning a license application, the Czech National Bank (CNB) shall consult with the banking supervisory authority or other supervisor of the relevant country if an international treaty so requires. A single license applies for

	banks having their registered offices in the member states of the European Union (EU).
Egypt	Not explicit. An application to obtain a license for opening a foreign bank branch in Egypt shall be accompanied by a statement indicating that the head office of the foreign bank is subject to the control of the monetary authority in the country where the head office is based and enjoys a specified nationality.
Estonia	Required. A document indicating the consent of the banking supervision authority of the home country to the establishment of a branch in Estonia is required as part of an authorization application.
Georgia	Banking licenses for a subsidiary or a branch office of a foreign bank will be granted only after consultations between the National Bank and the competent authorities of a foreign country which supervise the bank.
Germany	The Federal Banking Supervisory Office (FBSO) consults with the appropriate authorities in the home state before granting a license to conduct banking business to a subsidiary or an affiliate of a deposit-taking credit institution or securities trading firm. A deposit-taking credit institution or securities trading firm domiciled in another state of the European Economic Area may establish a branch office in Germany, if the institution is licensed by the appropriate authorities of the home state, and such business is endorsed by the home state authorities. For the establishment of a representative office, a notification must be filed with the FBSO.
Indonesia	Required. A statement of no objection to the establishment of a branch office in Indonesia issued by the banking authority of the country of origin of the bank head office must be attached to the application.
Jamaica	No information except as to branches established outside of Jamaica—required for an approval for the establishment of a branch outside Jamaica.
Kenya	Yes. For foreign banks submit a letter from the home supervisory authority recommending them to establish a Kenya branch.
Latvia	Yes. If a foreign institution holds 20 percent or more of a domestic bank's share capital or voting shares, or a foreign bank is opening a branch in Latvia, the foreign bank must submit a permission issued by the supervisory authority of the respective country, if required by that country, or a written statement by the authority to the effect that such permission is not necessary, and the authority has no objection. For opening a branch by a foreign bank, statements are required to effect that international standards will be applied.
Lithuania	Yes. The Bank of Lithuania will issue a banking license to a foreign bank subsidiary only if the bank supervisory institution of that country does not oppose it, and the laws of the foreign state permit

	its banks to establish bank subsidiaries overseas. For a foreign branch to register with the Bank of Lithuania, the bank supervision institution of foreign state must not oppose the establishment of a bank branch in Lithuania.
New Zealand	Considered. Where the applicant is a subsidiary or a branch of an overseas bank, the Reserve Bank will seek views of the parent supervisor before determining the application for a registration.
Peru	Yes. For the establishment of banks from abroad, the applicant should submit a certificate issued by the competent supervisory authority in the country of origin where a bank engages in its main operations, certifying that the applicant is authorized to establish offices abroad, and that the authority supervises it on a consolidated basis.
Philippines	Required. One of the requirements in the application for authority in an existing domestic bank in the Philippines is a certification from the bank's home country supervisor that it has no objection to the bank's investment. Adequate information on the bank and its subsidiaries shall also be provided to the host supervisor. The head office of foreign bank branches must guarantee a prompt payment of all liabilities of its Philippine branches.
Russia	Required.
Rwanda	Yes. Should the controlling owner of the bank or the financial institution be a foreign bank, a prior consent of the supervisory authority in the country of origin shall be required as a part of the licensing application.
Slovenia	Yes. Any shareholder of a subsidiary (if it is a foreign bank or another supervised financial institution) with more that 10 percent holding shall submit the approval or opinion from the home supervisory authority or the notification that in accordance with the regulations applying in that country such an approval or opinion is not required. For the establishment of a branch, a foreign bank has to submit approval (or notification in case of the EU member countries) of the home country supervisor for the establishment of a branch.
South Africa	Required. The Registrar shall not grant a license for a foreign branch unless he is satisfied that proper supervision will be exercised by the responsible supervisory authority of the foreign institution's country of domicile.
Switzerland	The responsible foreign supervisory authority must have no objection to the establishment of a branch in Switzerland and must be able to provide the Banking Commission with official support.
United States	Yes. In reviewing an application for foreign banking, the Office of the Comptroller of the Currency (OCC) will determine whether the home country supervisor has consented to the proposed

	establishment. In considering approval of a foreign bank's application, the Federal Reserve Board (FRB) may take into account whether the home country supervisor of the foreign bank has consented to the establishment of the branch or subsidiary.

Sources: IMF (2002), Bank Supervision Regulatory Database; and information from the respective country supervisory authorities.

III. Country Cases on Authority to Apply Regulations on a Consolidated Basis to Cross-Border Establishments of Domestic Banks

Australia	The Banking Act provides for the Australian Prudential Regulation Authority (APRA) to determine prudential standards in relation to consolidated groups. Prudential standards provide for supervision of capital adequacy and large exposures of an Australian-owned authorized deposit-taking institutions (ADI) on a consolidated group basis. To facilitate consolidated supervision of an ADI, the Banking Act also provides the APRA with the power to require authorized non-operating holding company (NOHC) of an ADI, subsidiary of an ADI, or subsidiary of an authorized NOHC to provide information relating to the NOHC or the subsidiary (including accounts and financial statements) and places certain requirements on auditors of these entities.
Bahrain	Yes. The Bahrain Monetary Authority is responsible for the supervision, regulation, and licensing of all bank and nonbank financial institutions operating in Bahrain.
Botswana	Not explicit. The Bank of Botswana may request any information it requires from a bank concerning operations of its subsidiaries abroad, if any.
Brazil	Yes. The central bank will only grant an approval for the organization of agencies abroad where it can access the information, data, and documents it needs to assess the asset and liability operations of those investments abroad so as to ensure consolidated overall supervision.
Czech Republic	Yes. A parent bank shall include in the consolidated entity all banks, financial institutions, and companies providing auxiliary banking services. If another parent bank is based abroad, exemption from supervision on a consolidated basis is possible only in exceptional circumstances. A consolidated group shall mean a parent bank group, or a financial holding company group, or a mixed-activity holding company group consisting of at least two entities.
Estonia	Yes. Provisions of the Credit Institutions Act apply to subsidiaries, branches, and representative offices of Estonian credit institutions in foreign states unless otherwise prescribed by the legislation of the host country.
Germany	Yes. Monthly returns may require particulars of subordinated enterprises located within Germany or abroad even if not included in supervision on a consolidated basis. Office may request information from companies domiciled in another state of the European Economic Area.

India	The prudential guidelines/norms issued by the Reserve Bank of India (RBI) to banks in India are applicable on a consolidated basis in respect of the prudential credit exposure limits, capital adequacy, country risk exposures among other things. In respect of the income recognition, asset classification and provisioning norms, and investment valuation norms, Indian banks have been advised to adopt either the home country norms or the host country norms, whichever is more stringent. Guidelines on a consolidated accounting are applicable to banking groups also. Prudential limits on prudential credit exposure limits have been extended to banking groups. The scope of consolidation will extend to foreign branches of Indian banks and all subsidiaries, joint ventures, and associates of a parent.
Indonesia	Bank Indonesia may conduct examinations of holding companies, subsidiaries, connected parties, affiliated parties, and debtors of a bank. Examination may be conducted to ascertain the compliance of the bank with Bank Indonesia regulations and guidelines.
Kenya	No information. An institution incorporated outside Kenya and a domestic institution that maintains branches outside Kenya is to submit to the central bank an audited balance sheet and profit and loss account of the institution as a whole.
Latvia	A bank is subject to supervision on the basis of consolidated financial statements of a group headed by a bank provided that the bank is a parent undertaking of another financial institution.
Lithuania	Yes. A parent bank and its subsidiary credit institutions or undertakings subjected to a consolidated supervision. A parent bank means a bank licensed by the Bank of Lithuania which controls other credit institutions (Commercial banks are licensed by the Bank of Lithuania).
New Zealand	Yes. New Zealand banks are supervised, and disclosure statements are required on a global consolidated basis.
Slovenia	Yes. The Bank of Slovenia (BOS) shall apply regulations on a consolidated basis to the subsidiaries abroad.
Switzerland	Yes. Cross-border inspections may be done to gather data necessary for a consolidated supervision over banks or financial intermediaries.

Sources: IMF (2002), Bank Supervision Regulatory Database; and information from the respective country supervisory authorities.

IV. Country Cases on Authority to Conduct On-Site Inspections of Cross-Border Establishment of Domestic Banks

Australia	Yes. The Australian Prudential Regulation Authority may appoint a person to investigate and report on prudential matters in relation to an authorized deposit-taking institution (ADI), an authorized non-operating holding company (NOHC), or a subsidiary of an ADI or an authorized NOHC if it is satisfied that such a report is necessary. The appointment must be in writing and must specify the prudential matters that are to be the subject of the investigation report. Such activities would be undertaken in consultation with a host supervisor with respect to local requirements.
Botswana	Yes. Foreign branches of domestic banks may be examined by the Bank of Botswana if it so specifies.
Canada	Where a Canadian bank acquires control of a foreign bank, that foreign bank must provide the Canadian bank with an undertaking to provide the OSFI with reasonable access to its records. Furthermore, the Bank Act provides that the OSFI may enter into an agreement with the home regulator concerning any matters it may consider appropriate, including limits on the activities of the foreign bank and access to information about the foreign bank. With respect to the OSFI's ability to examine cross-border establishments (branches outside Canada) of Canadian banks, the Bank Act provides that the OSFI may make or cause to be made any examination and inquiry into the business and affairs of the bank that the OSFI considers to be necessary or expedient to determine whether the bank is complying with the provisions of the Bank Act, and whether the bank is in a sound financial condition.
Estonia	The Banking Supervision authority has the right to carry out on-the-spot verifications of companies belonging to the consolidation group of a credit institution. The supervision activities of the Banking Supervision authority cover the subsidiaries, branches, and representative offices of Estonian credit institutions in foreign states, if they are not supervised by foreign supervisory bodies, or if correspondingly agreed with a foreign supervisory body.
Indonesia	Not explicit. The Bank Indonesia may conduct examinations of holding companies, subsidiaries, connected parties, affiliated parties, and debtors of a bank.
Lithuania	No specific authority for cross-border establishments has been named. The Bank of Lithuania has the right to inspect credit institutions holding a license and examine their accounts, books, and other documents. A parent bank must facilitate the Bank of Lithuania in obtaining information required about the activities of separate group members. A group means bank and subsidiary credit

	institutions or undertakings over which the bank exercises a significant influence.
Netherlands	Yes. The Bank of Netherlands (Bank) may request the supervisory authority in another member state of the EU to ascertain, by means of on-the-spot verification, the correctness of information furnished to the Bank or, after having obtained the approval of the supervisory authority, ascertain on its behalf through on-the-spot verification the correctness of information furnished.
Peru	Yes. The Superintendency may conduct on-site inspections of cross-border establishment of domestic banks according to the agreements with foreign agencies responsible for supervision of companies that make up conglomerates. Those agreements may include, inter alia, the exchange of information and the coordination of on-site inspections, as required.
Slovak Republic	Yes. The National Bank of Slovakia may perform on-site banking inspection of the branches of Slovak banks operating in a foreign country, unless the legal regulations of that country or relevant international agreement stipulate otherwise.
Slovenia	Yes, for branches and subsidiaries which are included in supervision on a consolidated basis under the condition that such on-site inspection is permitted by the foreign competent authorities.
Switzerland	Yes. The Banking Commission may undertake direct inspections in foreign establishments of banks. including subsidiary companies, branches, or representative offices, or other enterprises provided that their activities are included in a consolidated supervision.
United States	Every national banking association operating foreign branches must furnish information concerning the condition of those branches to the OCC. The FRB may order special examinations of those branches, banks, or corporations when it deems best. The FRB shall examine at least once a year and receive reports of condition from each "Edge" corporation (a corporation organized for purpose of engaging in international banking). The FDIC has the authority over operations of a foreign branch subject to FDIC regulation. Records, controls, and reports must be kept about foreign branches and foreign organizations and must be made available to the FDIC by insured state nonmember bank for examination and other supervisory purposes. The annual report of condition for each foreign branch is required as well as other necessary reports and information from time to time.

Sources: IMF (2002), Bank Supervision Regulatory Database; and information from the respective country supervisory authorities.

V. Country Cases on Authority to Have Contacts and Exchange Supervisor Information with, and Allow On-Site Inspection by, Foreign Financial Supervisory Agencies

Albania	Yes. The Bank of Albania shall cooperate with the foreign banking supervisory authority on a basis of reciprocity with respect to supervision and inspection of banks operating directly in both their jurisdictions. The Bank of Albania may exchange information with such foreign banking supervisory authorities concerning any bank operating in both their jurisdictions, provided such authority respects confidentiality of information received. A foreign bank branch is subject to inspection by the Bank of Albania or certified public accountants. The supervision authority of another country charged with prudential supervision of financial activities in that country is permitted to inspect a bank that is a branch or subsidiary of a foreign bank with its head office in that country or a significant interest in a foreign bank located in that country. Foreign bank and branch office are to cooperate fully with the Bank of Albania and certified public accountants
Australia	Yes. It is not an offense for the APRA to disclose protected information for purposes under law, or to assist a financial sector supervisory agency or any other agency (including foreign agencies) specified in regulations to perform its functions. Currently, a request by a foreign financial supervisory agency to conduct an on-site inspection of a foreign-owned subsidiary authorized as a deposit-taking institution and foreign bank branches is required on an informal basis by the Australian Prudential Regulation Authority. In these cases the APRA reserve a right to accompany an overseas regulator on such a visit.
Bahamas	Yes. The Inspector or its authorized agent may accompany the Supervisory Authority during its inspection within the Bahamas of a licensee.
Botswana	Yes. An official of a foreign bank or a foreign central bank, who has the responsibility of supervising that bank, may conduct an examination with the permission of the central bank subject to the duty of confidentiality.
Bulgaria	In exercising its supervisory functions, the central bank may conclude bilateral agreements with other central banks or foreign supervising agencies on the exchange of information on a reciprocal basis. To open a branch of a foreign bank requires a commitment to duly inform the Bulgarian National Bank of a commitment for cooperation in conducting on-site examination on premises of the branch in Bulgaria.
Cayman Islands	The Monetary Authority may disclose to the overseas regulatory authority information necessary to enable that authority to exercise regulatory functions.
Cyprus	Yes. Contacts are authorized with the appropriate recognized banking supervisory authorities outside of Cyprus.

Czech Republic	Yes. The CNB may be granted contractual provision of information by the banking supervisors in other countries. The CNB may ask a foreign supervisory authority to carry out an on-site examination in an entity that is supervised by the CNB and situated outside the territory of the Czech Republic. If a bank or an eligible financial institution concerned fails to take the necessary steps, the competent authority of the host state shall inform the competent authority of the home state accordingly.
Denmark	Yes. The supervisory authorities in another country within the European Union or within countries with which the community has concluded a cooperation agreement may, subject to advance notification, carry out inspection visits to branches of foreign credit institutions situated in Denmark but having their registered address in the country concerned.
Estonia	Yes. On the basis of cooperation agreements entered into with foreign banking supervision authorities, the Banking Supervision may authorize a foreign banking supervision authority to audit a subsidiary, branch, or representative office of a credit institution of the corresponding state in Estonia.
Georgia	Yes. The National Bank may exchange information with the foreign supervisory banking authorities concerning any bank that operates in both their respective jurisdictions, provided that such authority undertakes to respect the confidentiality of the information so received.
Germany	Yes. For institutions domiciled in another state of the European Economic Area (EEA) and for non-EEA states with reciprocity.
Indonesia	Yes. Based on reciprocity. Examination of a branch office of a foreign bank by the bank supervision authority may only be conducted with the approval of the Bank Indonesia. Examinations of a bank, whose shares are partly owned by a foreign bank conducted by the bank supervision authority of the country of origin of the foreign party, may be conducted only with the prior approval from the Bank Indonesia which shall be granted according to the principle of reciprocity.
Kenya	Yes, The central bank may disclose information to any monetary authority or financial regulatory authority, within or outside Kenya, where such information is reasonably required for the proper discharge of the functions of the central bank or the requesting monetary authority or financial authority.
Latvia	The foreign supervisory authorities are entitled to inspect the branches of banks of the respective country as well as banks whose parent undertakings are banks of the respective country. The Bank of Latvia is to be informed prior to inspection and entitled to participate. The Bank of Latvia is entitled to provide the foreign authority with the information necessary for performing the supervision where legislation of respective country provides for liability for unauthorized disclosure of confidential information.

Lithuania	The Bank of Lithuania is to perform checks of foreign bank branches to make sure accounting documents furnished to the Bank of Lithuania are accurate. The Bank of Lithuania may participate in inspections of foreign bank branches performed by the banking supervisors of a foreign state. Foreign bank branches are to furnish the Bank of Lithuania with the same financial and supervisory statements according to the same procedures as other commercial banks. Foreign bank subsidiaries also have to draw up and publish annual financial accounts by the requirements of the Bank of Lithuania. A foreign bank with a subsidiary or branch operating in Lithuania is to submit to the Bank of Lithuania the consolidated statement of the bank and entire group. All supervisory information received from a foreign bank, its subsidiary, or branch, banking supervisors of foreign states, or obtained during inspection, are to be confidential and not to be divulged unless provided by law.
Malta	Yes. On the basis of international agreements or upon reciprocity agreements, the authority may share its supervisory duties with other foreign competent authorities in the case of a bank or branch operating in Malta, which is fully or partly owned by a foreign person, or in the case of a bank fully or partly owned by Maltese residents which is operating abroad.
New Zealand	Yes. For information exchange, the authority is to disclose information and data obtained to any central bank, authority, or body in any other country which exercises functions corresponding to or similar to those of the Reserve Bank for purposes of exercising its functions, provided the Reserve Bank is satisfied with provisions that exist to protect confidentiality. The Reserve Bank maintains a close working relationship with parent bank supervisors on bank-specific issues, policy issues, and general matters relating to the condition of the financial system in New Zealand and in countries where parent banks domiciled.
Peru	Yes. The Superintendency may engage in coordination and sign agreements with foreign agencies responsible for supervision of companies that make up conglomerates. Those agreements may include, inter alia, the exchange of information and the coordination of inspections in situations as required.
Slovak Republic	Exchange of information between the National Bank of Slovakia and the banking supervision bodies of other countries is not deemed to be a breach of bank secrecy, provided that such information relates to entities operating or seeking to operate in a country concerned. The banking supervision authority of a foreign country may be allowed to carry out a banking inspection of a branch office of a foreign bank based in Slovak Republic, solely on the basis of an agreement signed between the National Bank of Slovakia and the relevant supervisory authority of the foreign country.

Slovenia	Yes. The BOS may exchange information with foreign supervisors if they need it for the implementation of their tasks of supervising under the condition of reciprocity and if these authorities are subject to the fulfillment of the secrecy requirements to the extent that specified in the Slovenian Banking Act. After May 1, 2004, the condition of reciprocity will not apply for the exchange of information with the supervisors from the EU member countries. On-site inspection of a foreign bank's branch in Slovenia by the foreign authorities is only possible with the approval of the BOS. After May 1, 2004, the supervisors from the EU member countries will perform an on-site inspection of branch's operations in Slovenia only upon the prior notification to the BOS.
South Africa	Yes. Before authorizing a foreign branch, the Registrar must be satisfied that home country supervisors adhere to the Basel Committee recommendations on minimum standards in respect of a consolidated supervision of banking groups and their cross-border establishments and recommendations relating to the supervision of cross-border banks.
Switzerland	Yes. Subject to professional secrecy and use of information only for supervision of banks. The Banking Commission may accompany the foreign banking and financial market supervisory authorities during their direct inspections within Switzerland.
United States	The FRB, OCC, and FDIC may disclose information obtained in the supervisory or examination authority to any foreign bank regulatory or supervisory authority if FRB, OCC or FDIC determines that disclosure is appropriate and will not prejudice interests of the country. Before any such disclosure, foreign authority must agree to maintain confidentiality of such information to the extent possible under applicable law. Subject to its discretion, any appropriate Federal banking agency may investigate and collect information at the request of a foreign banking authority. Factors to be considered are whether the requesting authority will reciprocate and whether a compliance would prejudice the U.S. public interest. For purposes of any Federal law or banking regulation relating to collection of information by any appropriate Federal banking agency, foreign banking authority shall be treated as another appropriate Federal banking authority.

Sources: IMF (2002), Bank Supervision Regulatory Database; and information from the respective country supervisory authorities.

VI. Country Cases on Equal Applicability of Domestic High Standards to Establishments of Foreign Financial Institutions

Albania	Yes.
Argentina	Yes. Branches of foreign institutions shall be subject to the Argentine laws and courts.
Armenia	No. No prudential standards are defined for branches of foreign banks, except the minimum reserve requirements in the Central Bank of Armenia.
Australia	Although foreign bank branches are not required to maintain endowed capital in Australia and not subject to the Australian Prudential Regulation Authority's (APRA) capital adequacy requirements and capital-based large exposure limits (responsibility of home supervisor), they are supervised in other respects on much the same basis as locally incorporated authorized deposit-taking institutions (domestic or foreign owned). They must meet the liquidity requirements, supply most of the statistical returns that other ADIs do, comply with certain requirements in respect of dealings with Australian subsidiaries and associates, and have in place the same external auditor arrangements. The Australian branch should adhere to APRA's prudential requirements, consult and be guided by APRA on prudential matters, and provide any information which APRA requires for prudential supervision of a branch. Foreign bank-owned subsidiary authorized deposit-taking institutions are subject to comparable legislative and prudential requirements to locally owned institutions and subject to prudential supervision by APRA. Authority to carry on banking business in Australia is granted to branches of foreign banks subject to a condition restricting acceptance of retail deposits. Deposit-taking activities are confined to "wholesale" markets. Branches of foreign banks are not permitted to accept initial deposits from individual and non-corporate institutions of less than $A250,000, but can accept deposits in any amount from incorporated entities, nonresidents, and employees.
Bahrain	Yes. Licensing process applies to foreign branches and representative offices of foreign banks. Regulations apply to locally incorporated and foreign banks. For example, notification to the BMA of major changes to corporate strategy or management is required.
Botswana	Not explicit. The Bank of Botswana may request any information it deems necessary from a representative office of a foreign bank concerning its operations in Botswana.

Brazil	Yes. The provisions of the Banking Act are applicable to foreign financial institutions operating in Brazil. The National Monetary Council shall apply to foreign banks operating in Brazil the same prohibitions or equivalent restrictions as are applicable to Brazilian banks established or desiring to be established where such foreign banks have their headquarters. The granting of authorization for representation of an institution with its head office abroad is conditioned on a letter of application which states that such institution knows and accepts the terms of the specific regulations in effect in Brazil.
Bulgaria	Yes.
Canada	Yes. Canadian banks owned by foreign banks are subject to the same regulatory regime as other Canadian banks. Foreign bank branches are subject to a similar regime, with some variance having regard to the fact that they are precluded from engaging in retail deposit taking activities.
Czech Republic	Yes.
Egypt	Yes. Representative offices shall be subject to the control of the central bank. All banks conducting business in Egypt are subject to the Banks and Credit Law.
Estonia	Yes. Provisions of the Credit Institutions Act apply to all credit institutions founded or operating in Estonia and to the subsidiaries, branches, and representative offices thereof.
Georgia	Yes. A branch of a foreign bank, as any other commercial bank, must be in compliance with all requirements and prudential banking normative established by the National Bank.
Germany	Yes.
India	Yes. All prudential norms applicable to Indian banks also apply to foreign banks in India.
Indonesia	Yes. A fitness and propriety test applies in a licensing process and on an ongoing basis to controlling shareholders and management of the commercial banks, defined as including a branch office of a foreign bank. The Bank Indonesia may conduct examinations of representative offices of foreign banks.
Kenya	Not explicit, but the Banking Act defines a bank to mean a company which carries on a banking business in Kenya.
Latvia	No special treatment noted. A foreign bank that has established a branch in Latvia shall invest in assets in Latvia not less than one million euros during the year after the receipt of the license and shall maintain this level of investment throughout the period of its operation.
Lithuania	Yes. Supervision of foreign bank branches are subject to the same laws and legal acts of the Bank of Lithuania as applied to other commercial banks. Supervision of subsidiaries of consolidated

	foreign banks carried out by the banking supervisors of foreign state. In supervising the activities of foreign bank subsidiaries, the prudential requirements for the bank activities approved by the Bank of Lithuania apply. Supervision of foreign bank branches is carried out by banking supervisors of home state. However, the Bank of Lithuania monitors liquidity, deposits, financial ratios, assets and liabilities developments, income and expenses, and evaluates influence of operation on financial market and risk factors. Foreign bank branch must comply with the liquidity requirement approved for commercial banks.
Malta	Yes.
Netherlands	Yes. With respect to an enterprise or institution established outside the Netherlands, which pursues the business of a credit institution in the Netherlands through a branch the provisions of the Act on the Supervision of the Credit System, shall apply to the business conducted in the Netherlands. A branch in the Netherlands of a credit institution established in another Member State shall, with respect to its business in the Netherlands, keep at least such accounts as will enable the Bank to perform its tasks. No institution established in a non-member state of the EU shall pursue the business of a credit institution in the Netherlands unless it has obtained authorization from the Bank; the same is true for a branch of a credit institution from a non-member state of the EU.
New Zealand	Yes. Provisions of law and rules generally apply to all registered banks. Neither branches nor guaranteed subsidiaries of overseas bank required to comply with separation arrangements between bank’s board and principal shareholders applied to domestic banks
Peru	Yes. The provisions of banking law are applicable to branches of foreign banks. They have the same rights and subject to the same obligations as domestic companies of similar nature. The general provisions issued by the Superintendency may not include any special treatment that discriminates among companies established in the country with respect to similar ones abroad.
Philippines	Yes. In order to provide protection to the interests of depositors and creditors, the head office of a foreign bank branch must fully guarantee a prompt payment of all liabilities of its Philippine branch. Any right, privilege, or incentives granted to foreign banks or subsidiaries shall be equally enjoyed by and extended under the same condition to domestic banks.
Rwanda	The Banking Law applies to banks and other financial institutions carrying out their activities in Rwanda, no matter where their headquarters or main offices are located.

Slovak Republic	Yes. The prudential regulations generally cover branches of foreign banks.
Slovenia	Yes. Specific provision applies as to the monitoring of liquidity risk, statistics, and the activation of the deposit guarantee scheme for branches of the EU member states' banks.
South Africa	Yes. Foreign institutions subject to specific conditions for the conducting of business in South Africa, including requirement that the institutions on its own or with its banking group have held net assets of at least US$1 billion. A branch must hold endowment capital, defined as an amount by which unencumbered assets of the branch exceeds the liabilities of the institution in the Republic of at least R250 million or a minimum of 8 percent risk weighted. Fit and proper criteria apply to the executive officer of a branch.
Switzerland	Yes. The Banking Commission can require that foreign banks fulfill all legal provisions for Swiss banks. The Federal Law on Banks and Savings Banks applies to offices, branches, agencies, and permanent representatives of foreign banks in Switzerland.
Tunisia	Yes. Nonresident financial institutions are also liable for a standard tax assessment in favor of the state and local government budgets and a fee for each branch and representative office. Nonresident institutions may be audited by the Central Bank of Tunisia.
United States	Yes. Operations of a Federal branch of a foreign bank conducted with the same rights and privileges as national bank and subject to same duties, restrictions, penalties, liabilities, conditions, and limitations that apply under the National Bank Act. Each Federal or State branch of a foreign bank is subject to limitations and conditions with respect to purchasing, selling, underwriting, and holding of investment securities set forth at 12 USC 335. The FRB must approve foreign bank applications to establish a branch, agency, or commercial lending subsidiary in the United States; a foreign bank must be subject to comprehensive supervision or regulation on a consolidated basis by its home country. The FRB shall consider whether a foreign bank will provide adequate information on its operation of affiliates to allow determination whether U.S. laws have been observed. If a foreign bank is not subject to a comprehensive consolidated supervision, its U.S. operations may be discontinued or made subject to supervisory restraints. The FRB shall apply comparable

	capital and management standards to a foreign bank that operates a branch or agency or owns or controls a commercial lending company in the United States.

Sources: IMF (2002), Bank Supervision Regulatory Database; and information from the respective country supervisory authorities.

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