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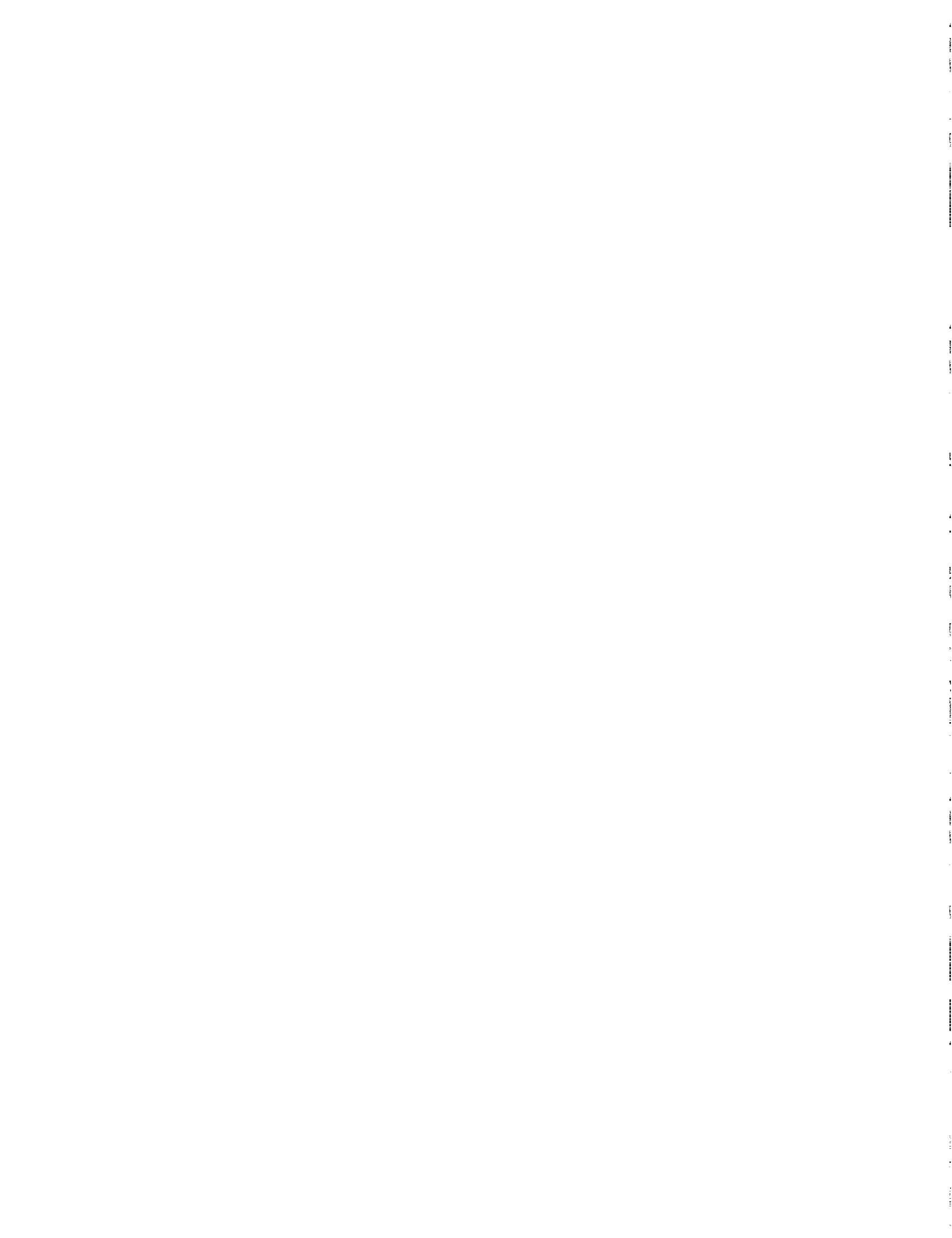
Report to the Chairmen, House Committee  
on Banking, Finance and Urban Affairs  
and Senate Committee on Banking,  
Housing and Urban Affairs

February 1986

# INTERNATIONAL BANKING

## International Coordination of Bank Supervision: The Record to Date







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National Security and  
International Affairs Division

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The Honorable Fernand J. St Germain, Chairman  
Committee on Banking, Finance and Urban Affairs  
House of Representatives

The Honorable Jake Garn, Chairman  
Committee on Banking, Housing and Urban Affairs  
United States Senate

This is our report on the activities of the Basle Committee, the main group of banking supervisors dealing with international coordination of bank supervision.

Given the constraints arising from its multilateral nature, we believe the Basle Committee has made progress in reaching agreement on international bank supervision issues. Important issues remain and are the subject of the Committee's attention. Reaching agreement on these remaining issues is likely to be difficult. We also concluded that the Committee could release more information about its work.

Copies of this report are being sent to the Comptroller of the Currency, the Chairman of the Board of Governors of the Federal Reserve System, and other interested parties.

A handwritten signature in cursive script that reads 'Frank C. Conahan'.

Frank C. Conahan  
Director

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# Executive Summary

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In recent years, financial institutions both in the United States and in other nations have rapidly expanded their overseas offices. These foreign offices may reduce the safety and soundness of banking when they extend beyond the supervisory control of the parent country. Bank regulators are concerned about a "competition in laxity" in which weak regulation in other countries allows their banks to conduct business that would be deemed imprudent and prohibited in their own countries. The Basle Committee, an advisory group composed of representatives from the United States and 11 other major industrialized nations, deals with this concern through efforts to coordinate bank supervision.

The Chairman of the House Banking Committee was concerned about the lack of knowledge of the Basle Committee's activities, and Congress subsequently passed legislation providing for GAO to review the status of international coordination of bank supervision. GAO therefore focused on the accomplishments and remaining work of the Basle Committee. In addition, GAO examined whether the Basle Committee could release more information about its activities. In a forthcoming report GAO will examine the extent to which the regulations, policies, and procedures of U.S. bank supervisors are consistent with the principles agreed to by the Basle Committee.

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## Background

The Basle Committee has been the main forum for international coordination of bank supervision since its creation in 1974. It meets about three times a year to

- define responsibilities for supervising the foreign offices of banks,
- examine particular risks arising in international banking, and
- develop personal relationships which can facilitate needed exchanges of information among supervisors.

Agreements are reached in the Committee by a consensus of the representatives, but the Committee has no power to ensure that these agreements are adopted by member nations through appropriate modifications to their countries' laws, regulations, or procedures.

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## Results in Brief

In this review, GAO had no direct access to the work of the Basle Committee. The scope of the review was therefore limited primarily to documents and other information provided by the U.S. bank supervisory agencies represented on the Basle Committee. Within this framework, GAO concluded that, given the constraints arising from its multilateral

nature, the Basle Committee has made progress in reaching agreement on international bank supervision issues, including gaps in the supervision of foreign offices of banks. Committee representatives have committed themselves to seek action by their respective governments to effect implementation of Committee agreements. Important issues in bank supervision remain and are the subject of the Committee's attention. Reaching agreement on the remaining issues and having them implemented by member countries is likely to be difficult.

GAO believes the Basle Committee could release more information on its activities. Publication of Committee papers on general bank supervision principles and summaries of its activities would not compromise any confidentiality and could help to dissipate concerns about the work of the Committee.

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## Principal Findings

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### Accomplishments of the Basle Committee

Since its formation, the Basle Committee has addressed sensitive bank supervisory issues, especially those that arise by virtue of the spread of banks' foreign offices. It has allocated the responsibility for supervising these foreign offices between countries where the offices are located and those in which the banks are headquartered. Sharing responsibilities in this manner should make it less likely that a foreign office will completely escape supervision. The Committee has stressed that these responsibilities should extend to all offices of a banking organization, even those not viewed as a bank by some nations.

The Committee has also agreed that supervision of foreign offices should be adequate, as judged by bank supervisory agencies in both the parent and host countries. This requires that before allowing a foreign bank to conduct business within its borders, a country must be satisfied as to the nature of supervision exercised by the parent country.

The Committee has recommended that banking supervisors use the consolidation principle in supervising the international operations of banks. Through such an approach, a bank's worldwide activity is measured against the regulatory standards of its home country. Banks should thereby be less attracted to weakly regulated financial centers, since by operating in those locations they will not escape their home country's regulations.

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**Supervisory Issues Remain**

Important issues in international bank supervision remain and are the subject of the Committee's attention. Efforts to bring about a greater similarity in national capital standards have been underway at the Committee for more than 2 years. Fundamental national differences as to what capital is, how it is measured, and what amount is adequate all complicate the Committee's work in this area.

The Committee is also attempting to encourage a greater consistency in the provisions its members require for doubtful international loans. However, these provisions have differing regulatory and tax implications in each country, thereby making agreement difficult.

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**Publication of Information**

Basle Committee agreements and other Committee documents are made public in some cases, other documents are shared only with non-member supervisory agencies, and still others are not circulated outside of the Committee. Some of what has not been made public consists of general supervisory principles and summaries of the Committee's work.

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**Recommendations**

GAO is making no recommendations.

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**Agency Comments**

The Comptroller of the Currency generally concurred in GAO's findings and conclusions and stated that the report was an accurate and fair characterization of the Committee's work.

The Board of Governors of the Federal Reserve System, in keeping with its general practice for a GAO report which has no recommendations, did not officially comment on the report.



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**Abbreviations**

BIS	Bank for International Settlements
EEC	European Economic Community
GAO	General Accounting Office
OCC	Office of the Comptroller of the Currency
OECD	Organization for Economic Cooperation and Development

# The Need for International Coordination of Bank Supervision

The past several decades have witnessed substantial growth in the foreign presence and activity of financial institutions. Whether to support the increasing overseas operations of multinational corporations, to escape from domestic regulation, to expand into new areas of profit opportunity, or for other reasons, large banks from many nations have opened offices around the globe.

These cross-border presences of banks, however, enhance the risk of bank failure because offices may be established where regulation is weak. Foreign offices of banks may not always be within the regulatory reach of authorities that supervise their home offices. National supervisory authorities were slow to recognize and control the potential reduction of bank safety and soundness resulting from overseas operations. As these foreign offices continued to grow, however, the authorities became concerned about a "competition in laxity," in which weak regulation in other countries allows their banks to conduct business that would be deemed imprudent and prohibited in their home country.

Coordination among national supervisory authorities may promote effective supervision of these overseas offices. Supervisors may share information on individual financial institutions, learn about each other's regulatory systems, and allocate responsibility for supervision of overseas offices.

## Foreign Offices of Financial Institutions Have Grown Significantly

Various economic and financial developments in the world's financial markets in the past several decades, including the expansion of trade flows and the increasing multinational dimensions of corporate activity, have contributed to the simultaneous growth in the international business of banks in general and of overseas offices in particular. Regulatory influences and tax considerations have also stimulated the establishment of foreign offices.

Foreign banking offices can take several forms. Most closely linked to a parent bank are its branches. These units have no separate legal identity but are mere extensions of the parent bank in foreign locations. Closely akin to branches are agencies. Unlike branches, however, agencies cannot accept deposits. Parent banks may also operate overseas through subsidiaries. These institutions, in which the parent bank has a total or partial interest, are incorporated in the country where they operate (host country). Two or more parent banks can together form an independent banking office known as a joint venture.

The surge in worldwide foreign banking presences during recent decades was highlighted in a 1980 study by the Office of the Comptroller of the Currency (OCC), which indicated that 387 banks throughout the world had foreign branches or agencies in 1978, more than three times the number which had such offices in 1961. This study also reported that in 1979 520 banks throughout the world had some form of overseas office, including over 4,800 branches or subsidiaries. A recently released report of the Organization for Economic Cooperation and Development (OECD) confirms this trend for the United States. U.S. banks had 131 branches located abroad in 1960, but nearly 800 in 1980; they had 39 overseas subsidiaries in 1964, but more than 900 in 1980. According to a Federal Reserve official, overseas subsidiaries of U.S. banks increased to nearly 1,200 by 1983 while the number of branches decreased to about 750. At the same time, U.S. offices of foreign banks have also shown a similar, although not as dramatic, increase in recent years. Agencies and branches of foreign banks in the United States grew from 76 in 1972 to 291 in 1979 and to 442 in 1984; subsidiaries of foreign banks numbered 25 in 1972, 46 in 1979, and 55 in 1984.

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## Overseas Presences of Banks and Prudential Supervision

The proliferation of overseas presences of banks has complicated the work of bank supervisors. To an ever-increasing degree, banking activities have occurred outside their national borders and, therefore, outside their direct regulatory control.

A bank's headquarters is located in its parent country and is supervised by a parent authority. An overseas office of the bank is located in what is termed the host country and may be directly subject to the regulatory standards of a host supervisory authority. These standards may be more severe or permissive than those of the parent authority.

Adequate supervision can be hindered by these differences in supervisory standards. When establishing overseas offices, banks may seek those locations promising minimum supervision for competitive advantages. Parent supervisors, aware that this migration of offices can grow, might relax their supervision in response, resulting in a competition in laxity of regulation.

With the growing overseas presences of their banks, parent supervisors might broaden the scope of their prudential supervision to include the foreign offices of those institutions. But any attempt to exert complete control over these foreign offices raises national sovereignty issues, especially for subsidiaries, which have a legally independent standing in

the host country. Such an attempt may also be frustrated by secrecy restrictions, which hinder efforts by the parent supervisor to gather data from these overseas establishments. Assessing the risks assumed by a bank can be stymied when identification of the individual borrowers or depositors of its foreign offices are concealed.

Host supervisors are also affected by the movement of banking offices overseas. They obviously have a direct interest in offices of foreign banks resident in their country because these offices may affect domestic banks. Yet their influence over the condition of these offices is limited since such offices may be strongly affected by the condition of their parent banks, and the host supervisor has no direct regulatory authority over parent banks. Thus, with the development of overseas offices, both host and parent supervisors find their supervisory responsibilities subject to regulatory influences of other nations.

Difficulties confronting bank supervisors have also arisen by virtue of the development of the international interbank market. In the past decade, banks have greatly increased their financial dealings with each other, i.e., through the interbank market; much of it has been through overseas offices. While measurements of the size of the market are imprecise, the Bank for International Settlements (see p. 15) estimated that it exceeded \$900 billion in outstanding claims at the end of 1981. The transfer of funds in this market increases the interdependence of the banking community, as banks grow more reliant for their funding on financial institutions located in other countries. Interbank linkages may be efficient in transferring funds globally from savers to borrowers, but they may also be a channel through which the financial strains of one bank may be transmitted to the entire international banking community.

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## International Coordination Among Banking Agencies May Aid Effective Supervision of Overseas Offices

While banks in the 1960s and 1970s seized the new opportunities that international business presented and established numerous foreign branches and subsidiaries in overseas locations, their regulators only gradually recognized these new developments and their attendant risks to bank safety and soundness. National authorities responsible for supervising these worldwide institutions still heavily focused their concerns on the domestic banking activity within their borders. As the chairman of the Basle Committee (see p. 14) remarked in 1981, "It is difficult now to realize how little contact there was at that time between those responsible for banking supervision in major countries."

The prudential ramifications of international activities of banks became harder to ignore after bank failures in several countries in 1973 and 1974. Stimulated by these events, national supervisory authorities recognized that the growth of foreign offices of banks made necessary better and more formalized coordination.

Coordination among bank supervisors may improve the supervision of banks' international operations in several ways.

- Knowledge of supervisory systems in other nations may result in a greater understanding of how parent banks and overseas offices are supervised.
- Agreements may be reached on responsibility for supervising the foreign offices of banks.
- Efforts may be undertaken to move toward common approaches in national supervisory standards, thereby reducing any competitive advantages for financial institutions operating under weak supervisory systems.
- Information may be exchanged about particular financial institutions applying for foreign banking offices or encountering serious financial difficulties.

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## **Objectives, Scope, and Methodology**

Questions about the international coordination of bank supervision were raised in hearings on international bank regulation before the Subcommittee on Financial Institutions, Supervision, Regulation and Insurance, House Committee on Banking, Finance and Urban Affairs on April 20 and 21, 1983. At the hearings, the Chairman of the Subcommittee, who is also Chairman of the full Committee, expressed his concern about the secrecy and lack of knowledge surrounding the activities of the Basle Committee, the main group of banking supervisors concerned with international coordination issues. In light of the impact of the Committee's decisions on worldwide banking regulations, he believed that greater public awareness of the work of the Basle Committee was desirable. Subsequently, in the International Lending Supervision Act (Public Law 98-181, Nov. 30, 1983), the Congress provided for GAO to conduct "a review or evaluation of the international regulation, supervision and examination activities" of the Federal banking agencies, "including the coordination of such activities with similar activities of regulatory authorities of a foreign government or international organization." We therefore initiated this review to identify accomplishments of the Basle Committee to improve international coordination of bank supervision and the work that yet remains. In addition, we also examined whether

the Basle Committee could release more information about its activities. While the focus of our work was totally on the activities of the Basle Committee, we are completing a review in which we examine the extent to which the regulations, policies, and procedures of U.S. bank supervisors are consistent with the principles agreed to by the Committee.

In identifying the activities of the Basle Committee, we primarily depended on the U.S. banking agencies represented on these bodies. We had no direct access to the work of the Basle Committee; therefore the scope of our review was limited to the documents and other information provided by the agencies.

We concentrated our efforts on the Basle Committee because of its pre-eminence in the international coordination field and the congressional interest in its activities. U.S. representatives to the Basle Committee (officials of the Federal Reserve Board, Federal Reserve Bank of New York, and Office of the Comptroller of the Currency<sup>1</sup>) told us that they were unable to share with us all documents and papers of this group because of the sensitivity of the other member nations to disclosure. The Federal Reserve Board, the agency designated as our key contact on Basle Committee matters, made available to us only selected Committee materials in light of these concerns. The Federal Reserve Board, however, did give us most documents shared by the Committee with non-member bank supervisors. (Some of these documents are publicly available.) These documents, according to the Board's representative to the Basle Committee, represent the principal results of Committee deliberations. A list of these documents is shown in appendix I. We did not obtain internal studies, minutes of meetings, reports of subgroups, or material relating to issues currently under study by the Committee. Moreover, our request to attend the 1984 international conference of bank supervisors was rejected.

We discussed the work of the Basle Committee, including that currently in process, with U.S. representatives to the Committee. We held extensive discussions with the Federal Reserve Board representative. We also discussed international coordination issues with senior officials of bank regulatory agencies in six European nations, all of whom represented their nations on the Basle Committee. Both U.S. and foreign Committee representatives were reluctant to discuss the Committee's ongoing and future work in more than generalities.

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<sup>1</sup>Since the beginning of our review, the Federal Deposit Insurance Corporation has become another U.S. representative to the Committee.

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**Chapter 1**  
**The Need for International Coordination of**  
**Bank Supervision**

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However, we believe that our access to Basle Committee documents and our discussions with its representatives were sufficient to enable us to identify the activities of the Committee to make some judgments about its work.

Through the discussions we held with U.S and foreign supervisors, we also obtained information on the activities of other international groups concerned with the coordination of bank supervision. OCC's representative to OECD's Expert Group on Banking acted as the primary source of information regarding this group.

# Basle Committee Accomplishments in Coordinating International Bank Supervision

The Basle Committee was created in 1974 by the central bank governors of the Group of Ten (G-10) nations,<sup>1</sup> plus Switzerland, to improve coordination in bank supervision among its member nations. It is the primary means through which bank supervisory officials from the major industrialized countries can exchange ideas and reach agreements in supervising the foreign establishments and other international activities of financial institutions.

In the Committee's first decade of existence, representatives from its member countries have supported the following principles for supervising banks' international operations that should offer greater stability to the international banking system.

- Agreed on the allocation of supervisory responsibilities for banks' foreign offices between parent and host-country supervisors.
- Recommended that parent supervisory authorities supervise their banks on a consolidated basis, thereby including all the business of a financial institution, whether at home or abroad.
- Emphasized the interdependence and shared responsibilities of parent and host supervisory authorities, agreeing on the need for each to identify the extent and adequacy of supervision practiced by its counterpart authority.
- Stressed the importance of identifying the overall structure of a bank's organization to ensure that all its components are supervised,
- Identified best practices for banks and supervisors to consider in managing foreign exchange and country risks in international lending.

## Committee Organization

The Basle Committee is formally known as the Committee on Banking Regulations and Supervisory Practices but is referred to as the Basle Committee of Supervisors, after the city in Switzerland where it meets, or sometimes as the Cooke Committee, after its current chairman, W. Peter Cooke, Associate Director of the Bank of England. Representatives from each of its member countries attend its meetings. These nations are home to a substantial proportion of the banks operating in international markets.

Since the Committee's first meeting in February 1975, it has been chaired by a senior official from the Bank of England (George Blunden

<sup>1</sup>These countries actually number 11 (Belgium, Canada, France, Italy, Japan, Luxembourg, The Netherlands, Sweden, United Kingdom, United States, and West Germany).



from 1975 to 1977, and W. Peter Cooke from 1977 to the present). Usually each nation has two representatives on the Committee, one from its central bank and one from its bank supervisory authority. Some nations do not have a separate bank supervisory agency, in which case both representatives would be from the central bank, with one from the supervision department of that central bank.

Committee representatives meet approximately three to four times a year in Basle, at the headquarters of the Bank for International Settlements (BIS). BIS for many years has been a major forum for central bank governors to address jointly many international financial and economic issues. It also gathers data on the nature and size of the international banking market. The Secretariat of BIS serves as staff for the Basle Committee.

The Basle Committee reports to the central bank governors of the G-10 nations and Switzerland. Papers which Committee representatives have agreed upon and which are deemed to be of sufficient importance are sent to the governors with recommendation for approval.

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## **Committee Goals and Objectives**

The Basle Committee's first objective was to define the responsibilities for supervising the activities of banks' foreign offices. Two agreements, referred to as the original and revised Basle Concordats, attempted to do this.

A second objective is to examine particular prudential problems that arise by virtue of the international activities of banks, wherever conducted, such as foreign exchange positions and country risk monitoring. The Committee has worked to develop broad principles which national supervisory authorities are encouraged to review and adopt. However, it has not seen its role as pressing for a complete harmonization of national supervisory standards.

A final objective of the Committee is to be a vehicle through which the supervisory agencies establish close personal contacts, thereby facilitating cooperation in resolving mutual banking problems.

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## **Nature of Committee Meetings**

The Basle Committee provides a confidential forum for free discussion of important and sensitive supervisory issues. Yet, by its nature, the Committee also inherently sets limits to the extent and pace of international coordination efforts. Its agreements must recognize the diverse

financial and economic situations of member countries and be generally accepted by all members in light of these considerations. Furthermore, its representatives, once agreed on needed approaches to bank supervision, have little direct power to implement any legal or even some regulatory changes which may be needed in their nations.

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### **Operation by Consensus**

Representatives who participate in Committee meetings have told us that at typical meetings they discuss recent developments in international banking, exchanging information on trends in the banking industry or modifications to the regulatory systems in their respective countries. Members may also discuss draft papers on supervisory issues prepared by Committee staff (BIS Secretariat) or reports prepared by subgroups of the Committee. According to a U.S. representative, these papers are revised or redrafted based on the members' discussion and are adopted only by consensus. According to the Chairman, this need for unanimity before agreements are reached and forwarded to the central bank governors for approval can sometimes mean that progress appears slow. Yet as a body representing the interests of sovereign states, but without its own international legal framework, the Chairman believes such an approach is a necessity.

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### **Committee Has No Power to Change National Laws or Regulations**

After Committee recommendations are approved by the central bank governors, it is up to member nations themselves to identify and effect any needed changes in national laws or regulations. The Committee has no responsibility or authority in this regard and its conclusions and recommendations have no legal force on its member nations. In this regard, a Committee representative stated that the Committee's recommendations must depend on the strength of their presentations because each member country is free to decide what to do with them.

Representatives do commit themselves to work in their home countries for the principles agreed to by the Committee, according to several representatives. While they may have some ability to bring about needed changes in regulations of their national bank supervisory agencies, adequate supervision can also be affected by existing accounting standards or tax regulations, which are usually outside the regulatory reach of bank supervisors. In some cases, the principles supported by Basle Committee members require legislative change.

## Supervising Banks' Foreign Offices

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### Supervisory Responsibilities Have Been Allocated Between Parent and Host Authorities

One of the initial tasks confronting the Basle Committee was to define supervisory responsibilities for the foreign offices of banks. As banks established overseas branches and subsidiaries, national perceptions and practices differed as to whether supervision of these offices was the responsibility of host or parent authorities. The Basle Committee directly addressed this issue in two agreements that came to be known as the original and revised Basle Concordats.

#### Original Concordat

In September 1975, the Basle Committee members reached agreement on a division of responsibility for supervising foreign offices of banks. This agreement was not made public until 1981, but was soon referred to as the Concordat, and later as the original Concordat when its revision appeared. A basic principle recognized by this document and underlying the concern with this issue is that no foreign banking establishment should escape supervision.

In allocating supervisory responsibility for overseas offices, the original Concordat stressed that clear-cut rules cannot be specified for determining in each instance whether host or parent authorities are responsible for supervision. Instead, it identified which authority should have the predominantly supervisory responsibility, given the nature of the foreign office and the purpose of the supervision. Thus, the original Concordat provided that the supervision of liquidity (i.e., the short-term financial condition) of foreign offices should be the primary responsibility of host authorities, given these offices' heavy reliance on local practices and regulations in managing their liquidity positions. Responsibility for supervising the solvency (i.e., the long-term financial viability) of foreign offices varied by type. For foreign branches, mere extensions of the parent bank, the Concordat stated that solvency supervision was predominantly a parent authority responsibility. For subsidiaries and joint ventures, primary responsibility rests with host authorities.

The Concordat also recognized that not only should foreign offices be supervised but also that supervision should be adequate in the judgment of both host and parent authorities. The matter is more fully addressed in the revised Concordat.

Allocation of the responsibility of host authorities for subsidiaries and joint ventures needed modification in light of the added responsibility that parent authorities were to assume as part of consolidated supervision of banks. This principle of supervision, strongly endorsed by the Basle Committee several years after the original Concordat, states that parent authorities should monitor the overall risk exposure and capital adequacy of their banking groups, wherever their offices are located and whatever their form. (See p. 22.)

The original Concordat also did not fully recognize that the division of responsibility among supervisors might remain uncertain if nations had differing definitions of financial institutions; for example, if a supervisory authority did not assume responsibility for a foreign office because under its legislation the office was not considered a bank. While the Concordat recognized that differences in definition could lead to supervisory gaps, it did not offer potential examples of such problems (such as the existence of holding companies or non-banking organizations) or suggest specific actions for supervisors confronted by this situation. This gap in supervision became real in 1982 when the Italian bank, Banco Ambrosiano, failed, including its Luxembourg subsidiary, Banco Ambrosiano Holdings. Neither the Italian nor Luxembourg governments assumed responsibility for the failed subsidiary, in part because the subsidiary was technically a holding company and not a bank and therefore not supervised by either country.

These concerns led the governors of the central banks of the G-10 countries and Switzerland to request the Basle Committee to review the original Concordat and identify needed modifications. There had been a reluctance to disturb agreements already reached. The Committee, spurred in part by the Ambrosiano case, revised and expanded the original Concordat; the revision was approved by the central bank governors in May 1983.

The revised Concordat, formally called "Principles for the Supervision of Banks' Foreign Establishments," basically clarified and amplified the earlier document. Like the earlier one, the revised Concordat again cites two underlying principles: first, that no foreign banking office should

escape supervision and second, that the supervision should be adequate. It then specifically identifies some of the particular organizational structures of international banking groups (e.g. parent or intermediate holding companies and non-bank organizations) which could complicate adherence to these principles. In these cases, it calls for close coordination between the appropriate supervisory authorities to ensure that all units of a banking group's structure are supervised, especially those of a financial nature.

The revised Concordat increases the supervisory responsibilities given to parent authorities, to be consistent with the principle of consolidated supervision which the Committee had endorsed several years earlier. Thus parent authorities are given joint responsibility with their host counterparts for supervising the solvency of foreign subsidiaries.

The revised Concordat also calls for each supervisor, whether acting in a parent or host capacity, to assess whether the counterpart authority of each foreign office is capable of undertaking adequate supervision. Thus, host authorities should assess supervision of parent authorities, and parent authorities should judge host authorities. The specific guidance on this matter is contained in a Committee paper and is discussed below.

Finally, the new Concordat explicitly states that it deals only with the allocation of supervisory responsibility and does not address financial responsibility to provide support to banks in difficulty (the lender of last resort function).

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## Adequacy of Supervisory Systems

Committee guidance provides that the adequacy of parent country supervision should be assessed when banks apply to establish foreign offices. A U.S. representative to the Committee stated that this is perhaps the most important point at which to make these assessments, since a supervisory agency probably would have the greatest leverage over a financial institution at the time the institution seeks authorization for a foreign office. The Committee has stressed that at such times host authorities should contact the parent bank's supervisor to "establish the basis for future cooperation" in supervising the new office. The host supervisor should determine whether supervision of the parent authority exists and is adequate. If supervision is non-existent, the Committee recommends that the host authority discourage or prevent the entry of the bank. If the host authority regards the parent authority's supervision as inadequate, the Committee suggests that the host

authority refuse the bank entry or impose special restrictive conditions on its operations. If an office is proposed by a business which is not considered a bank in its own country, the Committee recommends that the host authority attempt to convince the parent authority to supervise this "non-bank," refuse the non-bank's application for an office in the host country, or impose restrictions on the office's operations.

In a similar manner, the Basle Committee has called for parent authorities to ensure that the foreign offices of their banks are adequately supervised. Thus, when a bank applies to open an overseas office, application procedures should require that the parent authority satisfy itself that it will receive regular information on the operations of this office and that the office will be adequately supervised by a host authority. Even when a parent country's law does not require banks to obtain authorization to open overseas offices, the Committee nevertheless believes that the parent authority should make these determinations upon being notified of the overseas office.

The Committee has not directly identified minimum standards that a supervisory authority must meet to be considered adequate. Several representatives to the Committee told us that developing minimum standards would exceed its authority or infringe on national sovereignty. The Committee, instead, believes that individual national authorities are responsible for judging whether their standards are adequate.

Many of the supervisors we spoke with cited difficulties in judging bank supervision in other nations. Obtaining sufficient data about a supervisory system to assure its adequacy can be a major hurdle, especially if the country is not well known in the international banking community. Although review of the laws, regulations, and organization chart of a country's supervisory authority may show a well-structured agency with broad powers, the agency may be ineffective in practice. In addition, changes in governments can cause a supervisory authority to intensify or lessen its activities.

A U.S. representative saw potential political implications in a negative assessment of another country's supervisory system, since diplomatic sensitivities may be encountered if one country deems another country's supervisory system to be inadequate. Furthermore, national laws or traditions for approving foreign banking entrants may also offer obstacles to assessing other supervisors. Several representatives claimed that a more rigorous review of applications from foreign banks would be counter to a traditional "open-door" policy that exists in some member

countries. Others believed that existing laws or regulations would not allow foreign bank applications to be rejected based on the adequacy of their supervision. Nevertheless, most of the foreign representatives to the Committee whom we talked with believe that mutual assessments of supervisory systems were significant in closing potential supervisory gaps.

Committee As a Forum for  
Exchanging Information on  
Supervisory Systems

Basle Committee representatives, at a 1984 international conference of bank supervisors, offered the Committee as a forum for exchanging information on supervisory systems and requested supervisory authorities to complete questionnaires describing their procedures as both parent and host authorities. The Secretariat of the Committee would receive the responses and make copies available to other supervisory authorities for their use in judging the supervisory capabilities of the respondents.

In this effort, the Committee has been careful not to appear as if it is imposing supervisory standards; rather, the proposal is designed merely to obtain information which would then be used by individual supervisors in making their own judgments. Furthermore, the information obtained from the questionnaires will be only a preliminary indication of a country's supervision and normally will not be sufficient in itself for a country to make a definitive assessment.

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Economic Conditions and  
Applications for Foreign  
Offices

The Committee has also identified economic conditions as having a role in supervisory decisions on banks' applications for foreign offices. It has stated that, in addition to assessing the nature of parent authority supervision, host authorities should review the general economic background in the parent country. The Committee has not indicated what action is advisable if the economic conditions are poor. A U.S. representative to the Committee has explained the Committee's message to mean that a host country should be especially cautious when the applying bank comes from a country with a history of economic troubles. Such economic difficulties might well affect the parent bank and cast doubt on its ability to support the foreign office. He suggested that host countries wait until economic conditions improve before approving the application.

## Consolidated Supervision Supported

The Committee has strongly endorsed the principle of consolidated supervision. Consolidated supervision calls for a parent banking supervisor to assess banks for prudential purposes in light of their total worldwide business, wherever conducted and whatever the structure of their organization. Using this approach, all the assets and liabilities of all parts of a bank (branches or subsidiaries) are aggregated, with any intrabank transactions netted against each other. By including foreign subsidiaries, which are usually separately chartered and incorporated in the host country, in the consolidation, the parent supervisor views the bank more broadly than from a purely legal standpoint in which its liability for any losses of the subsidiary would be limited to its relative ownership of the subsidiary. Yet such an approach may be needed because a parent bank may for business reasons commit its own resources to the operations of its subsidiary's business.

Consolidated supervision permits a supervisor to obtain a complete picture of the risks borne by a banking institution through examining (1) the aggregate outside exposure of the bank to third parties through its lending and investments, (2) the outside funding of the bank in total and aggregated by source and maturity, and (3) the global profitability of the bank. It allows the supervising authority to measure these risks against whatever prudential standards are mandated by its own laws or regulations.

With these objectives in mind, the Committee recommended the adoption of consolidated supervision by its member nations. With such consolidated data, it believes that supervisory authorities can "most satisfactorily" monitor the capital adequacy and risk exposure of banks. Measuring capital in relation to the total business of a bank might deter it from taking undue risks in foreign countries where the capital requirements are less stringent than in the parent country. As the Chairman of the Committee has written, "Consolidation in effect provides a clearer picture of a bank's overall exposure to risk and enables parent supervisors to apply their own standards to the monitoring of their banks' business irrespective of where that business is conducted."

The Committee also noted the value of consolidated supervision in assessing other prudential concerns. For example, whether a bank is lending too much to countries with debt problems is best shown by looking at all loans to such countries, regardless of where they have been booked. Similarly, whether a bank has too large a foreign exchange exposure is best determined by looking at the consolidated foreign exchange exposure of the bank.



The precise nature of consolidated supervision can be a matter of debate. The Committee has argued for a consolidation of all branches, as well as wholly or majority-owned subsidiaries. It has not concluded whether a parent bank's minority interests need receive the same supervisory treatment. (See p. 38.)

The treatment of majority interests in consolidation also has not been completely defined. For example, whether all or only 60 percent of the assets and liabilities of a 60-percent owned subsidiary should be aggregated with the parent bank is open for discussion. Aggregating all of a subsidiary's assets and liabilities (full consolidation) is the most conservative approach. It reflects the possibility that the parent bank, in practice, might have to assume a greater share of any major loss the subsidiary realizes than its percentage investment would indicate, if only to protect its reputation in the international banking market. On the other hand, as several representatives to the Committee told us, it is often impossible to know in advance under what circumstances a parent bank would incur a larger share of a loss than its percentage investment in the subsidiary. This argues for including only the parent's proportionate share of subsidiary assets and liabilities in the consolidation (pro rata consolidation).

The revised Concordat noted that to implement consolidated supervision, parent banks and authorities must have access to all relevant information about their banks' foreign branches and subsidiaries. The document states that banking secrecy provisions in some countries may be obstacles to the needed flow of data across national borders, thereby constraining consolidated supervision.

However, most of the representatives that we spoke with did not view existing secrecy restrictions as a significant obstacle to the flow of data needed for banking supervision. Several did mention that assuring adequate verification of data obtained from the nations was still not a settled issue.

The Committee has called for the cooperation of supervisors throughout the world to exchange needed information on financial institutions. It emphasized that host authorities should grant parent banks access to all necessary information about their foreign branches and subsidiaries and that information obtained by parent authorities should be "open to verification" by the host authority, external auditors, or on-the-spot examinations of the parent authority.

As important as it is to bank supervisors, the consolidation principle is not a panacea. All the assets included in a consolidated statement may not in fact be available to meet liabilities when needed, such as in a threatened bank failure. Restrictions on international capital movements may make it impossible for funds in foreign offices to be freely transferred to satisfy depositors' claims. As we have indicated, the legal responsibilities of parent banks for subsidiaries are limited and offer grounds for a denial of support. For these reasons, examining the financial position of individual components of a banking group without considering resources that might be available elsewhere in the group can be a sound supervisory technique. The Committee has recognized this, stating that consolidation should not result in parent and host supervisors neglecting to view individual foreign offices on an unconsolidated basis.

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### Communication Between Parent and Host Supervisory Agencies

A fundamental part of the Committee's message on supervising foreign offices is the continual need for close contact and communication among parent and host authorities. The revised Concordat calls for such contact and cooperation, especially when problems arise in these foreign offices. In these cases, (1) host authorities should ensure that parent authorities are informed immediately of any problems which arise in a parent bank's foreign offices and (2) parent authorities should notify host authorities when problems arise in a parent bank that are likely to affect the parent bank's foreign office.

The Committee also recommended consultations between host and parent authorities whenever the opening of a new foreign banking establishment is proposed. It has called on host authorities to contact parent authorities in order to establish the nature of the latter's supervision of the new venture.

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### Other Prudential Issues Addressed

The Committee addresses other prudential issues that arise when banks operate internationally. It has identified the specific risks involved and the roles of bank management and supervisors in controlling these risks. It generally has not recommended specific supervisory standards in these areas; instead, according to a U.S. representative, they are in the nature of "best practices" which supervisory authorities should consider.

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## Capital Adequacy

In recent years, the Committee has concerned itself with the adequacy of banks' capital, especially in light of their international activity. It has been particularly troubled by a general downward trend in the capital positions of banks in many nations. To date, the main fruit of its efforts has been a call for national authorities to resist further decline.

One of the main purposes of bank capital is to act as a cushion by absorbing unforeseen losses. Originally, according to a U.S. representative to the Committee, supervisors saw this function of capital as surfacing during a liquidation; therefore, they evaluated whether capital was sufficient to satisfy liabilities in the event of a bank failure. More contemporary views of capital stress its need to act as a buffer and to cover unanticipated losses incurred in the normal course of business that cannot be satisfied by current earnings. By protecting against unexpected losses, adequate capital also plays the important role of maintaining public confidence in a bank. Continued confidence is especially critical in current times when so much of some financial institutions' funding comes from volatile sources which could be redirected at the slightest hint of financial difficulty.

Committee supervisors were concerned by the steady decline in the level of their banks' capital in relation to the amount of business they undertook. Varying influences were cited by the Committee as leading to the reduction in these capital ratios, including the squeeze on bank profits resulting from enhanced domestic and international competition and the difficulty of raising capital in the equity markets in the light of the poor performance of bank stocks.

The Committee issued a paper in June 1982 calling for supervisors to resist any "further erosion" in capital ratios. It recognized that current capital requirements differed in its member nations, both in terms of techniques of measurement and definitions of capital used and suggested that a greater homogeneity in capital requirements is needed. This work is still in process and is discussed on page 35.) At the same time, the call for a halt to lowered capital ratios could not await the completion of this work, and so the Committee concluded that supervisors should not allow the capital of major banks to deteriorate from their present levels, whatever those levels may be.

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## Country Risk

The recent international debt crisis has led supervisors to examine more closely the risk associated with banks' lending to overseas borrowers. Such lending involves an additional risk to those present in all lending,

such as credit and interest rate risks. This additional risk, called country risk, is the risk that borrowers from a particular country may be prevented by political, economic, or social phenomena from repaying their international indebtedness entirely or in a timely fashion.

The product of the Committee's efforts related to country risk has been a paper, distributed to supervisory authorities and banks throughout the world, offering guidance on supervision of country risk. This document stresses that assessing country risk is primarily the role of banks, while supervisors are responsible for ensuring that banks have adequate methods and systems in place to make these assessments.

The Committee does not prescribe a specific measurement system for country risk. Instead, it offers what one representative termed "best practices" for banks and supervisors to consider as they assess country risk. The suggestions made to banks regarding country risk analysis include the following.

1. A bank's country exposures should be measured on a consolidated basis, including all of its overseas branches and subsidiaries.
2. Banks should identify the country risk applicable to items that do not appear on the balance sheet, including letters of credit and legally binding commitments.
3. Given the difficulty in certain cases of determining where country risk lies, banks' country risk systems should identify total exposures in each country in two ways: first, on the basis of the borrower's home country, and second, giving effect to any reallocation of risk that the transactions call for. For example, if a bank lends funds to a branch of country A's bank located in country B, the exposure would be shown as existing to both countries A and B.
4. Banks should establish country exposure limits and these should relate to their capital and reserves.

The paper calls for bank supervisors, in turn, to ensure that their banks have adequate methods of assessing, measuring, and controlling country exposures, giving consideration to the Committee's guidelines. The supervisor should examine the system as it operates, ensuring that it captures the total country exposures and that some form of country risk limits are imposed.

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## Foreign Exchange Risk

The failure of a German bank (Bankhaus Herstatt) in 1974 as a result of substantial foreign exchange losses heightened the interest of international supervisors in these types of transactions. The Committee has identified foreign exchange risks as a potential threat to the stability of the international banking system, and it issued a paper in 1980 describing the risks and the appropriate role of banks and their supervisors in managing them. It recognized the role of banks as market-makers in foreign exchange. By taking open positions<sup>2</sup> in foreign currencies, banks can assist in smoothing exchange rate fluctuations. But this foreign exchange activity should not result in banks assuming risks of such magnitude as to threaten their safety and soundness.

As with country risk, the Committee points to bank management as primarily responsible for coping with the risks in foreign exchange business. Bank management should set limits to these risks and maintain proper internal control over its foreign exchange transactions.

In addressing the supervisors' role in monitoring and controlling banks' foreign exchange positions, the Committee recognized the divergence that exists in current national practices in the area. It indicated that supervisors' approach to foreign exchange activity could include one or more of the following approaches.

- Examining banks' internal control procedures for foreign exchange transactions.
- Monitoring banks' foreign exchange positions.
- Setting formal or informal limits on these positions.

The Committee did not recommend any specific approach or address whether specific prudential limits on foreign exchange positions should be imposed, but it gave suggestions for each possible supervisory approach.

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<sup>2</sup>For any bank, its open position in foreign currency is its total assets minus total liabilities in that currency, plus foreign exchange contracts bought minus the contracts sold in that currency.

## Committee Relationship With Other Multinational Groups

While the Committee has been the primary forum addressing international coordination of bank supervision, other international groups are also examining this issue, including several regional groupings of nations not represented on the Committee. Other groups have memberships which partially overlap that of the Committee, but have different mandates or legal standing. Several of the regional groups have been strongly encouraged in their work by the Committee chairman.

Although most of the largest banks are located in the Basle Committee's member countries, a survey indicated that as of December 31, 1984, 157 of the world's 500 largest banks in terms of capital were located in other countries. Moreover, banks in other countries have established many offices in Committee countries. Thus, in the United States as of June 30, 1984, 48 percent of the foreign offices and 17 percent of the foreign bank assets were from banks in non-Committee countries.

The Committee relates to these other regional groups in several ways.

- Several Committee members are also represented on the other bodies.
- The chairman or other Committee members attend regional group meetings.
- Discussions of activities are held at periodic international conferences of bank supervisors.
- Summaries of activities of regional groups are included in Committee annual reports.

The Basle Committee has recognized that, for its work to be fully effective, its message needs to be communicated to supervisory agencies in non-member countries. It has therefore established relationships with bank supervisory agencies of such countries, encouraging the formation of regional groups, and periodically meeting with them to exchange views on current supervisory issues.

In recent years, the Committee chairman or other representatives have attended meetings of regional groups of Latin American, Asian, and Off-shore supervisors and have met with supervisors from European countries not represented on the Committee. The Committee has also sponsored three international conferences of supervisors, in London in 1979, Washington in 1981, and Rome in 1984, to encourage personal relationships among officials of these organizations.

Nearly 100 countries were represented at the 1984 international conference in Rome. According to a press release issued at its conclusion, the

representatives present endorsed the principles of the revised Concordat. Yet, as has been demonstrated with some of the Basle Committee countries, the road from endorsement to implementation can be long. In fact, a U.S. representative to the Basle Committee indicated that, in his view, the endorsement of the Concordat given by some representatives was not without reservations.

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### **European Economic Community**

The nations of the European Economic Community (EEC)<sup>3</sup>, have committed themselves to developing a common banking market, including coordinated banking laws. Several years before the Basle Committee was created, discussions were begun by banking supervisors of the EEC countries aimed at increasing cooperation and assuring adequate supervision of international activities. Since that time, directives have been issued aimed at achieving closer harmony in the banking laws and regulations of EEC nations.

In signing the Treaty of Rome in 1957 which created the EEC, members hoped to foster economic development and stability in the EEC and closer relations among member states. This was to be achieved in part by establishing a common market with free movement of goods, services, and capital and developing a common banking market.

In pursuing this common banking market, the EEC considers harmonizing banking supervision to be a crucial element. This goal of bringing greater uniformity to banking supervision in the EEC differs from the more limited objective of the Basle Committee to achieve only greater "convergence" in members' regulatory approaches. At the same time, the EEC's efforts are supported by a legal framework, the Treaty of Rome. This is in contrast to the advisory nature of Basle Committee principles.

These distinctions between the Basle Committee and the EEC may not, however, have had much impact in practice. Several participants in EEC activities indicated that initial efforts in the late 1960's and early 1970's for a sweeping harmonization of banking legislation and regulations, including among other things uniform solvency and liquidity ratios, ran up against objections by member nations. This prompted the EEC to

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<sup>3</sup>As of mid-1985, 10 nations were EEC members—Belgium, France, Germany, Italy, Luxembourg, the Netherlands, the United Kingdom, Denmark, Greece, and Ireland. The latter three countries are the only EEC members not participating in Basle Committee activities. On the other hand, the United States, Canada, Japan, Sweden, and Switzerland are members of the Basle Committee but are not EEC members.

adopt a more gradual step-by-step approach to harmonization by issuing a series of directives on individual bank supervisory issues. The EEC's Council of Ministers has approved two such directives, to be subsequently implemented by each member country.

The first "banking coordination" directive, adopted in 1977, sets out minimum criteria that countries should require of newly established banks before they are authorized to do business. It also requires EEC nations to calculate the solvency and liquidity of their banks according to a uniform method. The results would be used initially for observation purposes only, although they offer the possibility of future use for actual harmonization of solvency and liquidity requirements. Finally, the first directive established an Advisory Banking Committee, a high-level policymaking committee of officials from EEC bank supervisory agencies, central banks, and government ministries. This group's purpose is to assist the EEC Commission in its coordination work.

The EEC adopted a second directive in 1983 which required member countries to supervise banks on a consolidated basis. The directive requires consolidation of all majority-owned subsidiaries, including those located outside the country where the head office is located. It also requires member countries to eliminate all legal obstacles to the exchange of information necessary for consolidation. EEC members were given until July 1, 1985, to change their national legislation, if necessary, in order to comply with this directive.

Aside from the somewhat formal coordination efforts of the EEC and, in fact, prior to most of them, the supervisory authorities of the EEC countries decided to establish an informal group whose purpose was to foster close personal relationships among those supervisors. Such close relationships, it was believed, would facilitate exchanges of information about specific banks and other experiences and problems confronting bank supervisors. This group, known as the EEC Contact Group, initially met in 1972, 3 years before the Basle Committee commenced its activities. According to its chairman, in these meetings, generally held three times a year, members exchange information on particular problem banks operating in their jurisdictions, brief each other on new developments in bank supervision in their respective nations, and report on studies conducted on selected supervisory issues.

The Contact Group places significant value on its informal nature, according to the chairman. Thus, it restricts membership to one member



from each national supervisory authority, and they meet without technical advisers, assistants, or observers. The members are generally senior supervisors, involved on a daily basis with supervisory issues. These members attend in their personal capacity and are thereby able to express personal opinions without committing their national authorities to their views.

The Contact Group's studies are generally confidential. However, according to the chairman, for especially significant issues the Group often submits reports to other bodies, including the Basle Committee. This relationship between the two groups is also aided by the fact that the current Contact Group chairman also represents his nation at Basle Committee meetings.

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## **Other Regional Groupings**

Listed below are other regional groups of bank supervisory agencies that have been established, most of a rather recent vintage.

1. Nordic Supervisory Group. This group was organized in 1925, reflecting the close collaboration that has long existed among the Nordic countries. Comprising representatives of the supervisory authorities of Denmark, Finland, Iceland, Norway, and Sweden, its meetings initially were formal, almost diplomatic in nature. More recently, it has emphasized more frequent, less formal sessions. Its primary aim has been to exchange information regarding experiences in supervising each nation's banks, not to harmonize the national banking legislation of its members.

2. Offshore Supervisors Group. This group was formed in 1980 because of concern about the level of banking supervision existing in offshore banking centers; 15 offshore centers are currently represented in the group—the Bahamas, Bahrain, Barbados, Cayman Islands, Cyprus, Gibraltar, Guernsey, Hong Kong, Isle of Man, Jersey, Lebanon, Netherlands Antilles, Panama, Singapore and Vanuatu. Since its creation, it has seen its role as building relationships among the supervisors of these offshore centers as well as between them and other supervisory authorities. Indeed, a close dialogue has developed between this group and the Basle Committee, according to the latter's chairman. In 1982, the group and the Basle Committee agreed on a number of principles designed to promote supervisory cooperation. In particular, the offshore centers represented in the group agreed not to obstruct the flow of information from offices in their countries to parent banks, thereby facilitating consolidated supervision by parent authorities.

3. Commission of Banking Supervisory and Regulatory Authorities of Latin America and the Caribbean. All national agencies in the Latin American and Caribbean area responsible for the supervision and inspection of banks are eligible for membership in this recently (July 1981) created group. As of mid-1984, 23 such organizations had joined.

The purpose of this group is to promote close relationships among these bank supervisory agencies, to discuss mutual problems, and to encourage research, training, and technical assistance related to bank supervision. It has invited representatives from the Basle Committee and other supervisory authorities to attend its annual meetings as observers. It has recently established three technical committees to examine staff training, bank supervision in times of crisis, and exchanges of information among supervisors.

4. SEANZA Forum of banking supervisors. This group held its initial meeting in November 1984, with representatives present from supervisory agencies throughout Southeast Asia and the Pacific Basin. The chairman of the Basle Committee was the keynote speaker at this session. Japan, a member of the Basle Committee, is also a member of this new group, thus providing a link between the two bodies.

A group representing supervisory authorities from the Middle East is in formative stages, according to the chairman of the Basle Committee.

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### Organization for Economic Cooperation and Development

The Organization for Economic Cooperation and Development, an institution through which 24 of the major industrialized countries address international economic, financial, and trade issues, began an effort several years ago to identify and assess significant changes in its member countries' banking structures and regulations. In 1980, its Committee on Financial Markets created an Expert Group on Banking to carry out this project. This group comprises bank supervisory, central bank, and finance ministry officials from 23 of the 24 OECD countries, including all the Basle Committee nations plus 11 other countries. The United States is represented by the Comptroller of the Currency, whose representative is the co-chairman of the entire group, and by the Federal Reserve.

Unlike the Basle Committee, the Expert Group on Banking, according to its secretary, will not produce any specific recommendations or principles as a result of its work. Rather, its studies will discuss the policy implications raised by contemporary developments in banking. The group has issued reports on the internationalization of banking and on

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electronic funds transfer and plans to issue reports on international banking and monetary policy, asset and liability management, scope of prudential supervision, and a summary report.

# Important Issues Still Remain on the Basle Committee's Agenda

Basle Committee members recognize that despite work over the past 10 years, significant supervisory issues remain unresolved. There are international variations in capital adequacy standards, loan-loss provisions for international loans, and treatment of activities not reflected on bank balance sheets.<sup>1</sup> The Committee is working to reduce these international variations, but reaching agreement on these issues and implementing them will likely be difficult.

## Differences in Capital Standards

We have discussed the critical role of capital in ensuring the viability of banks and the call by the Committee to improve what it saw as a deterioration in banks' capital positions. Along with that recommendation, the Committee initiated further work designed to bring about a greater convergence in national definitions of capital and ultimately in capital requirements. (See p. 25.)

Some U.S. and foreign regulators believe that divergent capital requirements will have adverse prudential effects, as weaker standards of one nation can drive other nations to lower theirs to protect the competitive position of their banks. As one foreign supervisor stated, "In such a situation, both the ability to maintain capital adequacy and the wish to do so could be reduced." Even judging which capital requirements are indeed "weaker" can be a difficult task, since definitions of capital and approaches to measuring its adequacy differ.

Most supervisors represented on the Committee recognize the critical importance of capital to the safety and soundness of individual banks and impose some regulatory standards to ensure that capital is adequately maintained. However, Committee member nations differ over (1) definition and valuation of capital, (2) formula used to measure capital adequacy, and (3) minimum capital required using that formula.

Bank capital, as defined by countries, usually includes stockholders' equity and accumulated earnings. Some countries, however, permit capital to be adjusted by revaluing fixed assets to reflect current market values, while others continue to carry these assets at historical cost less depreciation. Securities owned by banks are included at cost in some countries and at market value in others, with resultant differences in

<sup>1</sup>These variations are discussed in the Board of Governors of the Federal Reserve System's, Report to Congress on Bank Supervision of the Group of Ten Nations and Switzerland (May 31, 1984), and by Richard Dale, The Regulation of International Banking, Woodhead-Faulkner, 1984.

capital. All or part of subordinated debt<sup>2</sup> and reserves set aside for loan losses (whether disclosed or not) are considered capital in some countries but not in others.

Once capital is defined, a judgement needs to be made about how to measure its adequacy; here, too, distinct national approaches exist. Some countries set capital standards based on its ratio to liabilities; others compare capital to assets. Still other countries attempt to "weight" certain assets, such as loans, for the presumed risks they entail and then compare these "weighted assets" to capital. Countries that use this latter approach assess risks differently and therefore place varying weights on various types of assets, such as loans to the private sector, to governments, or to banks. Finally, even if the Basle Committee countries did have a common method for measuring capital adequacy, they still would confront the question of what the appropriate minimum level of capital should be using that method.

As part of its efforts to achieve greater convergence in national definitions of capital and measurements of its adequacy, the Committee has agreed on a framework for measuring capital adequacy. While not replacing individual national standards, it is to be used by Committee members as a basis for comparing and analyzing capital positions of major international banks. The framework includes several alternative definitions of capital, ranging from a strict one comprising only stockholders' equity to broader definitions that include elements of somewhat lesser quality, such as reserves for loan losses and subordinated debt. The Committee will calculate capital ratios for a sample of each member nation's banks using these different definitions.

In these calculations, the Committee will compare capital to both equally weighted and non-equally weighted assets. For the latter comparison, the Committee has assigned weights to different classes of assets reflecting the presumed risks they entail. Thus, loans to the private sector are considered most risky and are weighted accordingly; loans to banks are given an intermediate weight; loans to governments are considered less risky and therefore are given a lower weight. Contingencies, such as guarantees, are included in the calculations at a weight somewhat more risky than that used for loans to governments.

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<sup>2</sup>Subordinated debt is issued by banks as a source of funds. Its repayment in any liquidation would be subordinate to (i.e., come after) claims of depositors and other creditors of the bank.

Upon completion of this effort, the Committee will review the results and determine whether the approach is a useful one in making international comparisons of bank capital. This work, however, will not in itself result in a narrowing of national capital adequacy standards. The Committee recognizes that objective but sees it as a longer term goal. Several Committee representatives stated that legal, fiscal, and historical differences among countries make adoption of common capital adequacy standards very difficult. Nevertheless, according to the Federal Reserve Board's representative, Committee members hope that the international comparisons of bank capital under the agreed framework might more sharply reveal the differences existing in capital standards and encourage individual supervisors to modify their national systems to narrow these differences.

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### **Differences in Provisioning Policies for International Loans**

A critical element in assuring the long-term soundness of banks is adequate provisioning (reserves) for possible loan losses. This issue has taken on added urgency ever since the international debt crisis raised new doubts as to the ultimate repayment of loans made to borrowers in some countries.

It is generally agreed that banks themselves have the primary responsibility for assessing the repayment prospects of their foreign borrowers and for provisioning for possible losses. Supervisory authorities and other government agencies, though, can directly or indirectly influence these provisions. Basle Committee member countries differ significantly in the extent to which provisions are deductible from taxes, provisions are considered part of a bank's capital, and minimum provisions are mandated for specific loans or groups of loans.

The Committee has been examining the adequacy of its member countries' provisioning policies for international loans since 1981. Its members have agreed that a more consistent approach is needed, especially in light of the "competitive distortions" that can exist if one country's banks are forced to maintain higher provisions than those of other countries. One representative to the Committee told us that the supervisor with the least stringent provisioning requirements could inhibit competing international banks from establishing provisions that they perceive to be more prudent.

The Committee has agreed that supervisors should call for strengthening provisions for international loans that they consider to be inadequate. It has stated a preference for specific rather than general provisions, if the loans whose quality is in question can be identified.

The Committee's goal of greater consistency in the provisioning policies of its members is still far from realization. As differences in these policies stem in part from varying tax and accounting policies, progress will be difficult to achieve, since changes in those areas take place very slowly, according to the Committee chairman. Several representatives to the Committee also told us that the international debt crisis complicates efforts to achieve consistent and more prudent provisions for international loans; provisions for overseas lending cannot be so severe as to discourage bank lending to countries to stimulate their economies and thereby facilitate debt repayments.

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## Liquidity Responsibilities of Host Authorities

Both the original and revised Concordats gave host authorities primary responsibility for supervising the liquidity of banks' foreign offices. However, according to a U.S. representative to the Committee, how to supervise liquidity has been discussed at Committee meetings but with few concrete results. In his opinion, part of the difficulty stems from divergent views among Committee members as to the nature of liquidity. Some countries see it as relating to the degree to which assets of a bank can be easily realized, while others take the broader view that banks' liquidity needs can be met by their continuing ability to obtain funds in the marketplace.

Several years ago, the Committee attempted to develop a common reporting system identifying mismatches in maturities between assets and liabilities in banks' international business. However, according to a U.S. representative, little was accomplished because of data inadequacies and the uncertainty of some supervisors as to how they would use the data collected from this system.

The Committee has recently formed a subgroup on liquidity and is identifying approaches used by its members in supervising liquidity, according to a U.S. representative.

## Extent of Consolidated Supervision

The Committee has reached no conclusions about the scope of bank activities that should be included in consolidated supervision. In particular, it has not specified whether minority interests should be consolidated nor has it identified how non-banking subsidiaries should be treated.

The Committee does not consider minority interests that currently are not subject to consolidated supervision to be a significant loophole in the international banking system, yet it does maintain that individual banks can be significantly affected by these subsidiaries. This was demonstrated by the recent insolvency of a German bank (Schroeder, Munchmeyer, Hengst) which was attributable to excessive lending to a single group of companies that was unable to repay the debt. A substantial portion of this lending was made through a minority-owned subsidiary of this bank and therefore was not considered lending by the parent bank under German supervisory standards.

Very small minority interests need not be included in consolidations, according to a paper issued by the Committee. However, no agreement has been reached on what represents a "small interest". The paper also states that consolidation of minority interests is appropriate where the parent bank has some degree of responsibility for the subsidiary. But disagreements arise in the attempt to translate this general statement into specific consolidation rules. Two schools of thought exist in the Committee. One believes that uniform rules for consolidating minority interests are unnecessary. The supervisor needs to assess on a case-by-case basis the parent bank minority subsidiary relationship (including such factors as the nature of the parent bank's investment, the importance of the subsidiary to the parent, and the financial strength of other shareholders). Only then can the supervisor determine whether consolidation is appropriate. The alternative view is that these factors are so difficult to weigh that consolidation of minority interests is the soundest course. Indeed, some who support this approach represent nations that require consolidation of small minority investments.

Non-banking interests also have not been completely addressed by the Committee. As a result of deregulation, banks in some countries may engage in non-bank activities, such as selling securities, insurance, and real estate. These activities add risks to those already existing in the banking operations of a financial institution. The Committee has recognized that combining the financial statements of banking and non-financial entities presents accounting difficulties that can make consolidation impractical. Even for non-banking activities of a financial nature, such



as leasing activities or finance companies, a complete consolidation may not be appropriate, in the Committee's view.

This leaves open the critical question of how to ensure that the risks of non-banking activities are supervised or at least prevented from affecting the banking business of a financial institution. The revised Concordat called for controlling non-banking risks. However, according to a U.S. representative, beyond this general goal, the Committee has not addressed operationally how to isolate non-banking risks.

The chairman and several other Committee representatives have stressed the increasing importance of this issue as financial deregulation takes place in many locations. They note that these issues are being grappled with domestically in many countries and recognize that overseas presences of financial institutions bring international dimensions as well.

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## **Activities Not Reflected on Bank Balance Sheets**

The chairman of the Committee has noted that with the heightened concern of regulators about the adequacy of banks' capital positions, banks have taken on more business that is not reflected on their balance sheets and that may not trigger the need for more capital. Banks operating in international markets, for example, are underwriting commercial paper issued by borrowers over an extended period of time, committing themselves to lend to the borrowers if at any time during that period there is not a sufficient market for the commercial paper. The risk from this commitment to lend at some future date, however, is not reflected in the banks' balance sheets. A recent OECD report on trends in international capital markets indicated that the "backing up" for the issuance of commercial paper grew faster than traditional syndicated loans during 1984.

The chairman of the Committee has indicated that these recent developments are the subject of increasing scrutiny at Committee meetings. The Committee, however, has not yet issued guidelines in this area, according to a U.S. representative, although at least one member nation has recently revised its regulations to require a measure of capital for certain commitments made by its banks. Limited attention has been paid to off-balance-sheet items as they relate to country risk and foreign exchange risk in Committee documents on these subjects.

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## Publication of Information

Much of the Committee's work is reflected in papers which have been agreed to by Committee representatives. Those deemed to be of sufficient importance are sent to the central bank governors of the G-10 countries and Switzerland with a recommendation for approval. At the same time, the Chairman will propose the extent to which papers will be circulated beyond the Committee. Some papers are kept within the Committee or other components of BIS, some are shared with outside supervisory agencies, and some are made available to banks and the public.

In our review of the dissemination of Committee documents, we identified whether documents whose circulation was restricted contained materials of a confidential nature or instead discussed general supervisory principles or summarized the Committee's work. Some of the papers not made public consist of general supervisory principles or represent a summary of the Committee's efforts during a given period and could, therefore, in our opinion, have been made publicly available.

For example, the Committee has not made public a paper on the principles it recommends that supervisors follow for approving applications from banks for establishing overseas offices. The paper calls for host supervisors to consider such factors as the standing of the parent bank, the adequacy of the parent supervisors, and the economic conditions in the parent country.

Another example of what could have been made publicly available is the Committee's paper on information sharing for effective supervision of banks' international activities. The paper includes recommendations that host countries allow parent banks access to information about the latter's foreign offices and that parent supervisors be able to obtain and verify information on the operations of their banks' foreign offices.

The Governors, in approving a paper, have the final word on distribution and, according to a U.S. representative, tend to be conservative in these decisions. In mid-1985, the Governors for the first time agreed to make available an annual report of the Committee—the one for 1984—to those requesting it.



# Conclusions

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Our access to Basle Committee documents was not complete but, from the information we were able to obtain, we believe that we have a sufficient basis to make some judgments about the work of the Committee.

The Committee has made progress on sensitive issues in bank supervision, especially in light of its constraints as a multilateral body working to accommodate the interests of 12 different nations. To reduce gaps in international supervision, it has supported the principle of consolidated supervision, allocated responsibility among supervising agencies for banks' foreign offices, and recommended that supervisory agencies assess their counterparts.

The Committee operates by consensus, and once its members reach agreement it has no power to assure that the agreement is adopted by member countries through appropriate modifications to their respective laws, regulations, or procedures. Some have criticized the voluntary nature of Committee operations, and its progress in certain issues has been slow. Yet it would be unrealistic to expect nations to cede their national sovereignty in the supervision of financial institutions or to expect national legislatures to automatically defer to guidelines of international bank supervisors. In a forthcoming report we will examine the extent to which the regulations, policies, and procedures of U.S. bank supervisors are consistent with the principles agreed to by the Basle Committee.

We believe that the Committee could release more information about its work. A greater willingness to publish information about its activities, without compromising any confidentiality, could help to dissipate concerns about the work of the Committee.

Although discussions among Committee supervisors regarding the activities and financial condition of individual banks deserve a high level of confidentiality, we believe that this is not necessary for the Committee's broader efforts in identifying useful regulatory practices and summarizing its work in international bank supervision. Only a portion of the Committee's efforts are distributed to non-member supervisors, and an even smaller segment is shared with the public. For example, until 1985 the annual reports of the activities of the Basle Committee and other international supervisory groups, basically descriptive documents, were kept within the supervisory community.

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## Agency Comments

The Comptroller of the Currency stated that he generally concurred in our findings and conclusions on the progress the Committee has made for assuring cooperation among bank supervisors of member countries. He also said that he believed the report accurately and fairly characterizes the Committee's work.

The Board of Governors of the Federal Reserve System, in keeping with its general practice for a report which has no recommendations, did not officially comment on the report.

# Documents Shared by Basle Committee With Non-Member Bank Supervisors (January 1975 - May 1985<sup>a</sup>)

Year Issued	Title
1975	Report to the Governors on the Supervision of Banks' Foreign Establishments.
1976	Report to the Governors on the Possibilities for International Cooperation in a Problem Bank Situation.
1976	Report to the Governors on the Status of Foreign Banks' Branches (limited to 15 recipients) <sup>b</sup> .
1977	Report on Affiliation Relationships Between Banks and Non-bank Companies and on the Exercise by Bank Executives of Plural Functions.
1979	Consolidation of Banks' Balance Sheets: Aggregation of Risk-bearing Assets as a Method of Supervising Bank Solvency.
1979	Deposit Protection Schemes in G.10 Countries. (limited to 14 recipients)
1979	The Supervision of Country Risk in Bank Lending.
1979	The Treatment of Minority Participations in the Consolidation of Banks' Balance Sheets.
1980	Proposed Standard Inter-bank Confirmation Request.
1980	Supervision of Banks' Foreign Exchange Positions.
1980	Report to the Governors on Banking Secrecy Provisions as a Constraint on the Coordination of International Banking Supervision.
1981	Chairman's Paper to New York Conference.
1981	Banking Secrecy and International Cooperation in Banking Supervision.
1982	Management of Banks' International Lending: Country Risk Analysis and Country Exposure Measurement and Control.
1982	Report on International Developments in Banking Supervision in 1981.
1983	Report to the Governors on the Capital Adequacy of Banks Operating Internationally.
1983	Report on International Developments in Banking Supervision in 1982.
1983	Report on Relations Between the Basle Committee and the Offshore Supervisors' Group.
1983	Report to the Governors on Authorization Procedures for Banks' Foreign Establishments.
1983	Principles for the Supervision of Banks' Foreign Establishments.
1984	Statement on Inter-bank Confirmation Procedures.

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**Appendix I**  
**Documents Shared by Basle Committee With**  
**Non-Member Bank Supervisors**  
**(January 1975 - May 1985<sup>a</sup>)**

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<b>Year Issued</b>	<b>Title</b>
1984	Report on International Developments in Banking Supervision in 1983.
1984	The Implementation of the Concordat.
1985	Report on International Developments in Banking Supervision in 1984.

<sup>a</sup>Except as noted, these documents were made available to GAO.

<sup>b</sup>Not made available to GAO. According to the Federal Reserve, this document could not be located.

# Comments From the Comptroller of the Currency



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Comptroller of the Currency  
Administrator of National Banks

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Washington, D.C. 20219

December 12, 1985

William J. Anderson  
Director, General Accounting Division  
United States General Accounting Office  
Washington, D.C. 20548

Dear Mr. Anderson:

Receipt is acknowledged of your draft of a proposed report entitled "International Coordination of Bank Supervision, The Results so Far, the Agenda Remaining." The draft discusses the activities of the Basle Committee and makes no recommendations.

Accordingly, our review for comment focused on the conclusions reached. We generally concur in your findings and conclusions with respect to the progress the Committee has made in assuring cooperation among bank supervisors of 12 industrialized nations. We believe that the draft accurately and fairly characterizes the Committee's work.

Thank you for the opportunity to comment.

Sincerely,

Robert L. Clarke  
Comptroller of the Currency



# Comments From the Board of Governors of the Federal Reserve System



BOARD OF GOVERNORS  
OF THE  
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

OFFICE OF STAFF DIRECTOR  
FOR MANAGEMENT

December 17, 1985

Mr. William J. Anderson  
Director  
General Government Division  
U.S. General Accounting Office  
Washington, D. C. 20548

Dear Mr. Anderson:

I am responding to your letter of November 14, 1985 in which you enclosed for the Board's comment copies of the General Accounting Office's (GAO) report on the Basle Committee (Code 483397).

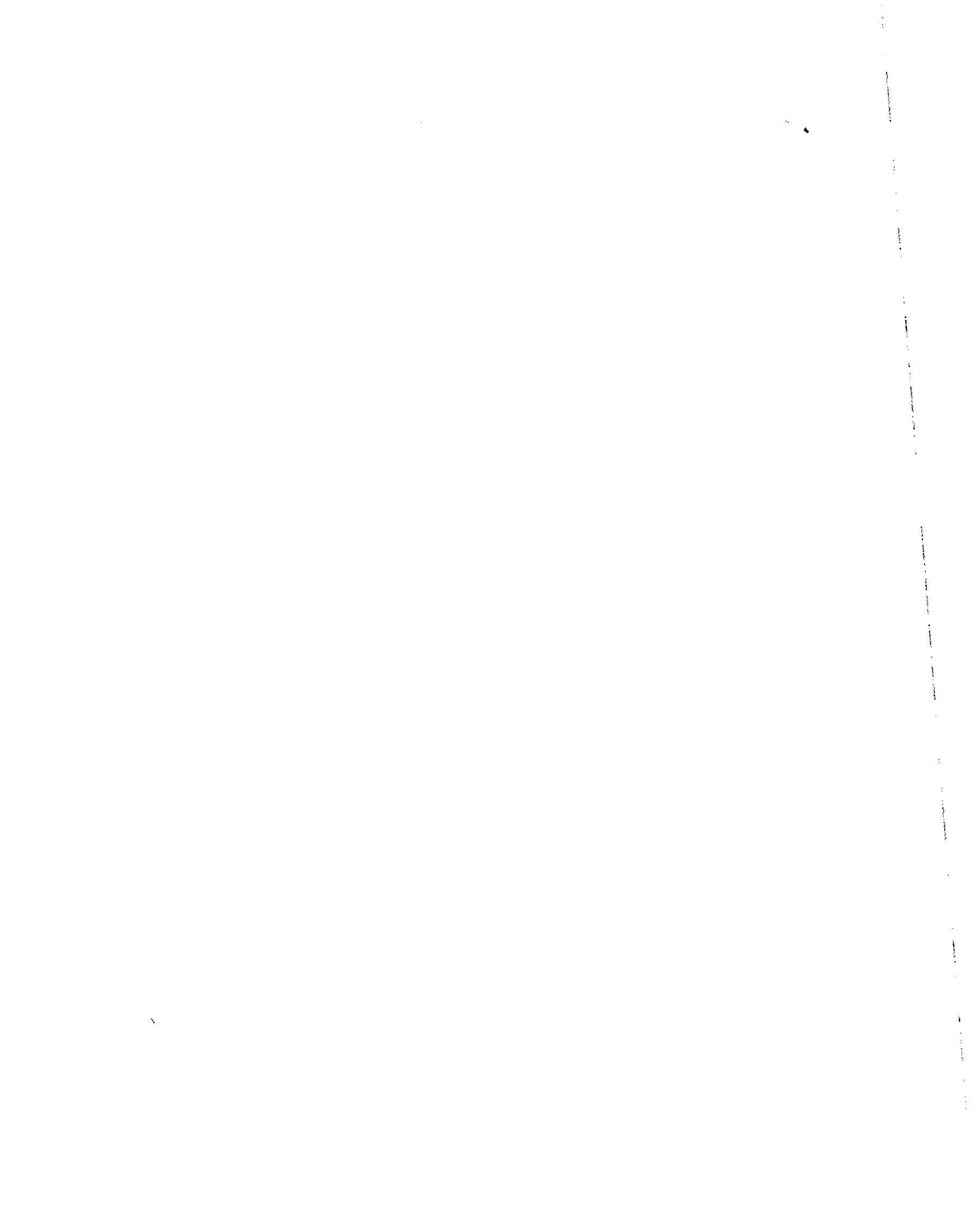
Except in unusual situations, it is the Board's general practice to comment formally only on draft GAO reports that contain recommendations to the Federal Reserve. Since the above named report contains no such recommendations, the Board will have no formal comments to offer.

Thank you for providing us with the opportunity to comment on the report.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Edward T. Mulrenin".

Edward T. Mulrenin  
Assistant Staff Director



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