

International co-operation in banking supervision^[1]

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The need for international co-operation

Banking supervision has two principal objectives, which are closely connected: protecting depositors; and protecting the banking system as a whole by preventing weaknesses from developing in particular parts, which might undermine other parts of the system, or by containing such weaknesses if they have developed. For much of the period since the crisis of 1929–33, the main emphasis has been on the protection of depositors; and this emphasis drew strength from a political and social trend, evident in many countries, towards the protection of consumers and away from the principle of 'caveat emptor'. In recent years, however, the attention of banking supervisors has increasingly been turned towards the second objective – the protection of the system as a whole, since institutional developments in this period have made the protection of systems both more difficult and more necessary. It is on this aspect that I wish to concentrate first in this paper, because from it derives the need for international co-operation in supervision.

Traditionally, banking consisted of the acceptance of deposits from customers and their employment on advantageous terms in a variety of assets in proportions designed to achieve reasonable balance between the sometimes conflicting objectives of liquidity and profitability combined with the avoidance of undue risk. Banking skills lay essentially in achieving the best disposition of assets. In the last two decades, however, there has been something of a revolution, with bankers moving increasingly towards the active management of their liabilities as well. If an attractive loan proposition is presented to a banker, he will no longer reject it simply on grounds of lack of funds at his disposal, but will approach other financial institutions to borrow. Banking skill has been broadened to include the achievement of the best disposition of liabilities as well as of assets; and liquidity has been seen as a function of borrowing as well as of investment.

Thus, the contemporary financial system is characterised by banks taking funds from, and lending them to, not only their customers, but also each other through various money markets. If one bank defaults, the consequential losses are no longer confined to its depositor customers; depositors with other banks are also likely to be affected if default through the markets brings down other banks. In this way, relatively insignificant defaults by fringe institutions can have wide repercussions, not only because of their effects on

the public's confidence, but also directly. The more integrated the financial system, the more rapid can be the spread of infection from weakness in one of its parts.

The growing interdependence of banks and other financial institutions has not been confined within national boundaries but has transcended them. This internationalisation has been associated with a sequence of developments since the restoration of convertibility to a wide range of leading currencies in the 1950s. First, there was the development of unimpeded foreign exchange markets; then, fostered partly by internal regulations in the United States, the emergence of the euro-dollar money markets; this in turn led to the development of the euro-bond markets and the international syndicated loan markets. At the same time, to take advantage of these new markets, there was a steady increase in the number of international financial institutions through the proliferation of foreign branches and subsidiaries of previously national banks, the linking of banks from different nations and finally the creation of consortium banks with parents from many different countries.

This period also saw the emergence of developing and intermediate countries as borrowers in international markets and the rapid growth of the multi-national companies. Lending to multi-national companies involves risks which do not apply to national companies; for example, the difficulty for banks of discovering the total liability of a multi-national company to them, when loans may have been made to any number of the company's subsidiaries by many different banks throughout the world in a variety of currencies; the susceptibility of such companies' long-term plans to disruption by political caprice; their overall exchange-rate exposure; and the effects on corporate cash flow of changes in national taxation and foreign exchange controls.

For some years, these international developments went largely unheeded by the main national supervisory authorities, for the good reason that they had no immediate cause for concern. During the 1960s, the international markets grew steadily and smoothly, stimulated by US balance of payments deficits, which created a large pool of dollar holdings outside the United States, by impediments to the raising of capital in the United States by foreigners, and by the buoyancy of the world economy and international trade. The markets survived a number of currency devaluations and revaluations virtually unscathed. Indeed it was not until the end of 1973 that the potential weaknesses of the system began to become clear.

In 1974, much of the newly-acquired wealth of the oil producers was 'recycled' through the international markets, and, in the process, major international banks acquired a great accretion of very short-term liabilities some of which they transformed into much longer-term international assets, but some of which they passed on short-term to smaller, often less strong, international banks which in turn transformed more of them into long-term assets. At the same time, exchange rates no longer had the same degree of official stabilisation as they had had under the 'par value' system, and the

[1] Previous material in the *Bulletin* on banking supervision has been: *The supervision of the UK banking system*, an earlier talk by Mr George Blunden, June 1975, page 188; *The capital and liquidity adequacy of banks*, a paper agreed between the Bank of England and the London and Scottish clearing banks, September 1975, page 240; and *Banking supervision: statutory control or self-regulation*, a speech by the Governor, December 1975, page 367.

strains on the adjustment process of the balance of payments of the main industrialised countries had been multiplied several times by the oil price rises. The result was unstable exchange rates and rapidly changing domestic monetary conditions. These strains were superimposed on an unsettled situation, as the business cycles of the main industrialised countries coincided for the first time in the recent past, and the consequent world-wide inflation itself undermined public confidence in financial assets and markets in them.

These developments greatly magnified the risks involved in international banking, and in other business which was exposed to fluctuations of exchange rates. Furthermore, in these circumstances there began to be doubts about the ability of some countries, with less robust economies, to service their obligations in the international markets, and of some multi-national companies, which depended on operations in these countries, to generate and repatriate adequate profits. At the same time, some banks' lack of dealers experienced in operating under a floating rate system, and inadequate management control over their dealers, increased susceptibility to the risks inherent in foreign exchange dealing in such circumstances.

The combination of these developments produced severe strains and, in a few well publicised cases, banks failed or incurred serious losses. These led to a severe loss of confidence in the international banking system and, for the first time, to the recognition of the need for international co-operation in the field of banking supervision.

The limits to international co-operation

In spite of the trend towards integration of banking systems across international frontiers, there are still great variations of business environment and methods within countries, and consequently great variations in national banking systems. These differences mean that it is not surprising, indeed it is essential, that bank supervision varies greatly between countries and retains its primarily national focus. For example, it would be foolish to try to impose the same system of supervision on the United Kingdom and on the United States. The former is a small integrated country with fewer than ten large domestic deposit banks, all with large branch networks but most with their head offices in London, and a large number of relatively small unit merchant banks also concentrated in London; the United States has a federal structure, and in it there are 14,000 deposit banks all of them confined to particular states or smaller areas.

In addition, each country's supervisory system has had to be accommodated within that country's legal and political system and an attempt to integrate it with the systems of other countries could often run into severe constitutional difficulties. Finally, although some of the larger banks in a country may have developed an international focus and character, many of the small and often less securely founded banking houses will have remained wholly national in their scope.

Even if these distinctive national characteristics did not exist, it would not be possible to move towards the

integration of national banking supervisory systems into an internationally coherent system, without the creation of a new supra-national supervisory authority. The banking system of a country is central to the management and efficiency of its economy; its supervision will inevitably be a jealously guarded national prerogative. Its subordination to an international authority is a highly unlikely development, which would require a degree of political commitment which neither exists nor is conceivable in the foreseeable future.

Developments in international co-operation

General

International co-operation has been concentrated in two main groups. Within the EEC, a directive to harmonise some broad aspects of national banking is at an advanced stage of preparation, and working groups have been set up, under the auspices of the European Commission, on this subject and on the co-ordination of accounting principles and balance sheets of credit institutions. But even with the degree of supra-national authority provided by the Commission and the other Community bodies, progress towards harmonisation is proving to be slow and difficult. Also within the Community, but not formally sponsored by the Commission, there is the 'Groupe de Contact' of the member countries' supervisory authorities. This is an informal gathering of supervisors, meeting periodically to foster mutual understanding and for confidential exchanges of information.

A drawback to co-operation between members of the European Community is that as yet in the banking sphere the Community is not a natural unit. The international banking system is far more extensive. This was a major reason for the establishment of the Committee on Banking Regulations and Supervisory Practices, composed of representatives of the supervisory authorities and central banks of the Group of Ten countries and Switzerland and Luxembourg; this was established in 1974 by the Governors of the Group of Ten, shortly after they had agreed that it was the duty of central banks to provide lender-of-last-resort facilities to their national banks to support their euro-currency operations. It is based on the Bank for International Settlements which provides its secretariat. The grouping consists more nearly of the countries housing the principal international markets and providing the principal banks operating in them.

Nevertheless, the Community provided the first vehicles for international co-operation of banking supervisors, and still provides a lead in the promotion of co-ordination of practices and schemes for the automatic exchange of information. The Group of Ten Committee, because of its more heterogeneous membership, deliberately does not aim at attempts to harmonise supervisory systems. Instead it aims to establish broad principles, with which all supervisory systems might conform in establishing their own detailed arrangements; it attempts to identify gaps in the supervisory coverage of international banking; it provides an opportunity for the supervisors who attend its meetings to learn from each other, with benefit to the supervisory practices of

all, so indirectly enhancing the likelihood of overall stability in the international banking system. In addition, it was specifically charged to search for a means of improving international early warnings of potential troubles in national banking systems, which might have international repercussions.

Early warning systems

The Committee quickly reached the conclusion that it would not be practicable to establish a separate reporting system, operated by an international body, to cover all international banking operations and to provide early warnings by identifying potential danger spots. Such arrangements would inevitably, in large part, wastefully duplicate existing national arrangements, would in many countries be incompatible with existing legislation, and would be very difficult to co-ordinate because of differences in individual banking and political systems. Early warning must continue to be derived from national supervisory systems, and action to counter potential dangers, even when they could have an international impact, must be taken by the national authority most concerned. So the Committee has concentrated on facilitating improvements to existing national arrangements.

First, it regularly studies and discusses different countries' supervisory techniques and innovations; it is noteworthy that in less than two years' life, representatives of virtually every one of the countries on the Committee have reported developments, sometimes major and sometimes minor, in their supervisory systems which they have attributed to knowledge of other countries' systems gained in the Committee. Several comparative studies have been documented by the Bank for International Settlements' secretariat as reference papers for the continuing use of supervisors. These studies have covered not only broad comparisons of the supervisory systems in operation and the regulations covering foreign exchange transactions in each country, their institutional background and their objectives, but also other more detailed matters. The Committee has, for example, examined the ways in which relationships between the banks and brokers are controlled in member countries; it has studied the various attitudes adopted by member countries to the role of loan capital in a bank's balance sheet, to requirements for endowment capital for foreign branches, to arrangements for bank audits and to control over potential clashes of interest, arising from banks' affiliations, both upward and downward, with non-banking companies and from involvement of banks' directors and managers in non-banking activities. Some of these studies have led to recommendations to the Governors of the Group of Ten of broad principles which should be applied to individual systems. And some of these recommendations have been passed for information to a wide range of other supervisory authorities throughout the world.

Secondly, the meetings of the Committee have offered an opportunity to representatives on the Committee to compare notes of a sensitive nature. Early warnings of potential troubles in banks are not derived just from supervisory inspections or examinations of returns; they may also be derived from market reports and from

confidential information given to supervisory authorities by commercial banks. No early warning systems can ignore such sources of information. Of course, the different laws and conventions about secrecy in different countries mean that some supervisory authorities are perforce more reticent than others; some have no freedom to talk at all. But that apart, it is clear that it is much easier to pass on such reports on a completely confidential basis with full assurance that recipients will realise their unconfirmed nature, if the people passing them know each other well.

In the past, there was very little contact between supervisory authorities, and so such confidential relationships did not exist. With the formation of the Groupe de Contact, they started to develop among the supervisors of the European Community countries. Now they are developing further; members of the Committee in Basle believe that the working relationships which are being established there, and which have already reached a considerable degree of intimacy, will ensure a high degree of mutual trust and understanding over a wider geographic range of countries. As members of the Committee have developed trust in each other, direct bilateral contacts between them outside the forum of the Committee room have also been facilitated. This network of contacts had its first practical test last year with the collapse of the small group of banks centered on the Banque pour l'Amerique du Sud. This situation was dealt with expeditiously and smoothly, with little effect on international markets or on banking confidence, by supervisors in four different countries working together harmoniously on the strength of relationships established at Basle.

The demarcation of responsibilities of national supervisory authorities

Thirdly, the Committee has aimed to establish guidelines for co-operation between national authorities in the supervision of banks' foreign establishments, and to suggest ways of improving the efficacy of that supervision. This has been one of its most urgent tasks, given the importance of these establishments to the foreign exchange and international money markets, and one which will be considered in more depth in this paper. There is agreement that the basic aim of international co-operation in this field should be to ensure that no foreign banking establishment escapes supervision. It is also agreed that each country has a duty to ensure that all foreign banking establishments in its territory are being supervised by somebody; and that, in the case of joint ventures involving parent institutions in more than one country, there is no practicable alternative to supervision by the authority of the country in which the venture operates. However, it is recognised that such a simple statement cannot be comprehensive: gaps of coverage will arise from differences between supervisors' opinions on what constitutes a foreign establishment; from differences of forms and standards of supervision in different countries; from the virtual absence of supervision in some popular 'off-shore' banking centres; and from differences in the type and scale of national and international banking problems.

The scope for making comprehensive guidelines is limited, but the Committee has tried to identify the demarcation between the responsibilities of the host supervisory authority for a foreign offshoot, and that of the parent bank, in relation to liquidity and solvency and to the control of foreign exchange operations. Taken together, at present these barely comprise guidelines, but they may ultimately develop as the nucleus for a 'code' of desirable working practice for co-operation between supervisors.

Thus, the Committee has concluded that responsibility for supervising the liquidity of foreign branches must rest, in the first place, with the host supervisory authority, but that a branch's liquidity cannot be judged wholly in isolation from that of the whole bank to which it belongs. This consideration brings its liquidity within the sphere of interest of the supervisory authority of the parent bank also. That authority, in assessing the liquidity of the parent, must take account of calls that its foreign branches might make on its liquid resources, and of the possibility that local practices and regulations may be less strict for the management of branches' liquidity in foreign currencies, especially in the currency of the parent bank, than for the management of liquidity in local currencies. Not all host authorities accept the same degree of responsibility for supervising liquidity in foreign currencies as they do for supervising liquidity in a local currency.

Host countries' prime responsibility for supervising the liquidity of locally-incorporated banks is more obvious. But the supervisory authorities of parent banks may also be concerned about the liquidity of foreign subsidiaries or joint ventures. For example, such banks may have stand-by facilities made available to them by their parent institutions. In such cases, the parent's supervisory authorities will need to take account of these facilities in judging the liquidity of the parent bank and will need to know the degree of importance which the host supervisory authorities are attaching to the stand-by facilities in judging the liquidity of the foreign establishment. Moreover, although the legal position of foreign subsidiaries and joint ventures is different from that of foreign branches, the parent authorities cannot be indifferent to the moral responsibilities of parent institutions for seeing that their offshoots do not default on their commitments; it is now widely accepted that it is expedient that parent banks should fully accept these moral responsibilities.

In ensuring solvency, it was again concluded that there must be some sharing of responsibility for supervision between host and parent supervisory authorities, with the emphasis varying according to the type of establishment concerned. For foreign subsidiaries and joint ventures, the primary responsibility must rest with the host authorities. However, parent authorities will need to take account of the exposure of parent banks, derived from their moral commitment to support their foreign offshoots.

The solvency of foreign branches is indistinguishable from, and integral to, that of the parent banks, and is therefore essentially a matter for parent supervisory authorities. But in those cases where host authorities

impose a requirement for 'endowment capital' on foreign branches, they will need to ensure that the requirement is fully maintained. The presence of endowment capital does not obviate the need for solvency control by parent supervisory authorities, for it is usually required for different purposes: most commonly, to ensure that the establishment of a foreign branch brings a minimum investment to the country; to ensure a commitment by the parent bank to the branch; and, above all, to equalise competitive conditions between branches and properly capitalised domestic banks.

Banks' foreign exchange positions are supervised partly for prudential reasons, partly for balance of payments reasons and partly to assist maintenance of orderly market conditions. Since foreign exchange transactions have a bearing both on liquidity and solvency, prudential supervision is a matter for host and parent authorities, with the division of interest between them following the lines of the analysis that I have already outlined. Balance of payments considerations and the maintenance of orderly markets are clearly the concerns of host supervisory authorities.

This examination of the demarcation of supervisors' responsibilities in relation to foreign banking establishments makes clear the need for co-operation between host and parent supervisory authorities; but, in this connection, the Committee pointed to a number of restraints which at present sometimes hamper co-operation between some countries. These include the prohibition, even when it may be mutually desired, of the exchange between supervisory authorities of confidential information, returns and reports given by a bank to its local supervisor; and the inability in some instances of a parent bank's supervisors to obtain information directly from, or by an inspection of, a foreign establishment of that bank. The Committee has given support to the extension of the ability of parent supervisory authorities to make direct inspections of their domestic banks' foreign establishments. These are already fairly common, sometimes on an informal basis and sometimes as a result of formal reciprocal arrangements between countries, but the Committee would like such arrangements to be extended as widely as possible. As an alternative, for those cases when direct inspections of a bank's foreign offshoots are not possible for legal reasons, the Committee has recommended that host supervisors should agree to undertake investigations on behalf of parent supervisors, making available a summary or the complete report of their findings. It is interesting to note that, since these recommendations on the desirability of increased co-operation were made, a number of countries have already taken powers under legislation, or have the taking of such legislative powers in prospect, to permit the passing of information gleaned for supervisory purposes to supervisory authorities in other countries.

Accounting practices

Another area in which there is an evident need for international co-operation concerns accounting and auditing practices. Within the European Community a directive is nearing completion designed to harmonise

the accounting standards and balance-sheet layout applying to all companies registered in the Community. Within the Basle Committee, there is a great awareness of the need for better international understanding of national accounting practices. Without this, judgments on commercial risk by participants in the international markets will be compromised, and banking supervision made more hazardous. The Committee's studies of particular cases have shown that differences of accounting and auditing practices between countries have been contributory factors to failure – by supervisory authorities, by auditors and by lending banks – to appreciate in time the seriousness of a developing situation. The Committee believes that this area is amenable to much closer co-operation, and that there can perhaps be a move towards a set of internationally accepted standards. To this end, it has initiated several inquiries into different aspects of accounting practices and is co-operating with the International Accounting Standards Committee in studies which, it is hoped, will lead to the production of proposals to harmonise national accounting standards and procedures applied to banks.

Risk estimation

An area which has been a subject of much interest and discussion, particularly within the European Community, has been the provision of mechanisms which can facilitate proper evaluation of commercial risk. Banking risks, of course, take any number of forms, but, in relation to international lending, two are pre-eminent: risks of default by borrowers, particularly companies; and risks of the economic failure of countries.

Several European countries have central bureaux to which all loans by financial institutions of a certain size are reported, and from which banks can discover the total borrowing of individual companies. Their aim is to assist the achievement of a better evaluation of company risk. Such bureaux also considerably help supervisory authorities. However, national bureaux are not much help in relation to multi-national companies, borrowing in many different countries. Consultation is taking place within the European Community aimed at a combination of national bureaux to form a Community-wide bureau. However, five of the member countries do not have central bureaux and some of them question whether such bureaux might lead to breaches of bankers' confidences, and whether commercial bankers in fact gain more than marginal benefit from the information they obtain from them; they suggest that a bank should acquire much more information about a potential borrowing company before deciding to lend to it than can be obtained from the simple aggregates available to a 'bureau des risques'. Further, a Community bureau would still be misleading in the case of most multi-national companies, whose operations range far wider than the Community.

Assessment of country risks is even less amenable to mechanisms of this type, and inevitably evaluation is even more subjective. However, the Bank for International Settlements working with the Group of Ten countries and Switzerland have in the past year developed statistics which give a much wider coverage of international lending analysed by borrowing countries

and which include, for the first time, lending through branches of US banks in certain off-shore centres. The Group of Ten Committee of Supervisors believes that these statistics should be drawn to the attention of, and be studied carefully by, all commercial banks engaged in international lending.

Conclusions

Inevitably, the activities of bodies responsible for international co-operation in banking supervision are to some extent a reaction to current developments. This paper has outlined the main areas of continuing study and development, but it should not be forgotten that most of the time of the members of these bodies is taken up in discussions on current developments. This is entirely appropriate. Strains in the international banking system often remain submerged until they are well advanced, and the translation from strain to crisis is alarmingly rapid, and often provoked by a seemingly unconnected event. The essence of international co-operation in this area is to spot the cause of strain before the explosion, and this entails constant vigilance and review. The one generalisation that can be made, and even then only with caution, is that the next source of strain will be different from the last one.

The lessons of the past are clear. It is likely to be by continuous monitoring of the banking scene and by confidential comparisons of views and exchanges of information that potentially dangerous developments can best be spotted and anticipated, and it is this function of mutual education which must remain the prime aim of international co-operation in the field.