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The Regulation and Supervision of Cross-Border Banking

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Summary

Financial market globalization and integration has been characterized by a significant expansion of banks conducting cross-border operations through branches and subsidiaries. This process has the potential to intensify in the context of the growing application of the "common passport" principle, which allows banks to operate in foreign jurisdictions, subject essentially to consolidated home supervision.

The main stimulus for the growth in banks' cross-border activities has been the desire to take advantage of economies of scale and unexploited international opportunities. While providing for efficiency gains, the process also raises challenges for national regulatory and supervisory authorities. Recognition of these challenges is evident in the multilateral efforts, spearheaded by the work of the Basle Committee on Banking Supervision, to devise and encourage the harmonized implementation of an international regulatory and supervisory framework (the "Basle Concordat"), which promotes efficiency gains while minimizing the opportunities for disruptive arbitrage among national jurisdictions.

The events leading to the recent closure of the Bank for Credit and Commerce International (BCCI) highlight the importance of appropriate regulation and supervision of internationally active banks. Owing to its structure, BCCI was not subject to consolidated supervision by its home authorities. The ability of host authorities to serve as proxies was undermined by several factors, such as incomplete information flows and fragmentation of lead regulatory responsibilities.

The analysis of the existing regulatory framework suggests that these gaps may be attributed primarily to the incomplete implementation of the framework rather than to its design. Nevertheless, its effectiveness could be reinforced by additional measures to improve financial incentives for appropriate home supervision and provide for greater use of market signals. Until the harmonized implementation by national authorities of a regulatory "common denominator," pressures for country-specific policy modifications aimed at containing the risks associated with cross-border banking are likely to increase. Indeed, steps have already been taken to alter recent trends in the distribution of home/host country regulatory responsibilities by providing greater scope for host country authority over the establishment and discontinuation of the operations of foreign banks. Accordingly, one of the challenges facing regulatory authorities in this interim period is to reduce the risk of supervisory oversight without undermining progress toward the adoption of a multilateral framework.

I. Introduction

The growth of banking institutions with cross-border branches and subsidiaries has been an important element of the continuing process of financial market globalization and integration. Its main stimulus has been the desire to take advantage of economies of scale and unexploited international opportunities, often in the context of increasingly competitive domestic environments. The process is likely to intensify under the expanding application of the principle of a "common passport," underpinned by consolidated home supervision on the basis of an internationally harmonized set of rules and procedures. At the same time, the process has raised major issues for national regulators and supervisors; these include assessing the nature and magnitude of risks within cross-border financial institutions, and devising appropriate means to contain them while avoiding "over-regulation" that thwarts the process and its associated efficiency gains. Indeed, appropriate consolidated supervision of banking groups with activities in several national jurisdictions has proved to be one of the important and difficult challenges facing multilateral collaboration in the financial services area.

Several key issues associated with the regulation and supervision of international banks were illustrated in the events surrounding the closure of the Bank of Credit and Commerce International (BCCI). On July 5, 1991 eight regulatory jurisdictions took steps to halt the operations of the bank; this was followed by similar actions in other jurisdictions, with a total of over 60 countries suspending BCCI's operations. While the closure entailed financial losses for shareholders, depositors, deposit protection schemes and creditors, its systemic consequences--in terms of disruptions to national banking markets and the working of the payments and settlements systems--were minimal. This was due in part to the international coordination of key regulatory actions, as well as limited inter-bank exposures to BCCI of major financial institutions. At the same time, however, questions have arisen about the effectiveness of the international regulatory and supervisory framework in the early detection and reversal of irregularities at BCCI. Consequently, the BCCI episode has already induced changes in some national policies, as well as proposals for the strengthening of the international regulatory and supervisory framework.

This paper discusses the major issues that confront the regulation and supervision of internationally active banks, including through an analysis of some of the characteristics peculiar to the BCCI case. It is organized as follows: Section II describes the current multilateral framework for the regulation and supervision of international banks (the "Basle Concordat"), highlighting its development into an approach centered on the techniques of consolidation and exchange of information between home and host authorities. Section III reviews briefly the evolution of BCCI since its inception in 1972, focusing on the organizational structure and its regulatory implications. Section IV summarizes some of the regulatory and supervisory implications of the BCCI case and discusses some recent proposals and actions to strengthen the regulatory process.

II. The International Regulatory and Supervisory Framework

While appreciating the efficiency gains associated with the cross-border expansion of banking activity, national regulators recognized early on that the process involved certain risks which, if not adequately countered, could ultimately have adverse implications for the integrity of domestic and international banking systems. In addressing these risks, regulators have worked together to devise an appropriate analytical framework and ensure its harmonized and comprehensive cross-border application in order to minimize the opportunities for regulatory and supervisory arbitrage. 1/

As detailed below, the initial focus of multilateral efforts was on formulating "best practices" guidelines for the sharing of regulatory and supervisory responsibilities between host- and home-country authorities. This was reflected in the 1975 Basle Concordat, which was agreed to by the major industrial countries. Difficulties in specifying the distribution of responsibilities in specific cases, as well as the further evolution of banks' international activity, led to increased emphasis being placed on the need to consolidate the regulation and supervision of financial activities as a means of getting a better handle on the totality of banks' worldwide operations. Accordingly, the Concordat was revised in 1983 to endorse the principle of consolidation whereby the home regulatory authority was given responsibility to monitor the risk exposure of internationally active banking groups on the basis of all their business activities wherever these might be conducted. In addition to the G-10 countries, the revised Concordat received the broad endorsement of some 75 other countries at the 1984 International Conference of Banking Supervisors (ICBS). As indicated below, the work done in specifying the Concordat identified many of the difficulties facing consolidated regulation and supervision--difficulties that were subsequently manifested in the BCCI episode--and proposed measures to limit the associated risks.

1/ A useful conceptual framework for analyzing the issues facing the regulation and supervision of international banking services is provided in a recent G-30 study (Key and Scott (1991)). The authors develop a "banking matrix" that illustrates the relationship between (i) public policy goals (e.g., competitive markets, avoidance of systemic risks, safety and soundness, etc.); (ii) the method of providing cross-border banking services (essentially branches versus subsidiaries); and (iii) the configuration of host-country, home-country, and harmonized rules. The authors argue that the choice of regulatory and supervisory rules depends essentially on the interaction between the manner in which the banking service is provided and the public policy goals.

1. The 1975 Basle Concordat

The guidelines for cooperation between national authorities in the supervision of internationally active banks were set out in the Basle Concordat, issued on September 26, 1975 by the Basle Committee on Banking Regulations and Supervisory Practices. 1/ The basic aim was to ensure that no foreign banking establishment escaped supervision. 2/ The guidelines represented recommendations of "best practices" which member countries represented on the Committee undertook to work toward implementing. The Concordat stressed not only the importance of all foreign banking establishments being supervised in both the host and home countries, but also that such supervision be deemed adequate when judged by the standards of both host and home authorities. To this end, the Concordat emphasized the importance of contact and cooperation between host and home supervisory authorities. Proposed actions included direct transfers of information between national supervisory authorities, direct inspections by home authorities of their domestic banks' foreign affiliates, and indirect inspections of foreign banking establishments by home authorities through the agency of host countries.

Beyond these general principles of cooperation, the Concordat attempted to lay out a number of specific guidelines regarding the allocation of responsibilities for regulating two key aspects of banks' operations--liquidity and solvency. 3/ In doing so, distinction was made among three types of foreign banking structures: branches (viewed as integral parts of the foreign parent banks); subsidiaries (legally independent banks incorporated in the host country and controlled by a foreign parent bank); and joint ventures (similar to subsidiaries but controlled by two or more parent institutions).

The supervision of foreign banks' liquidity was deemed to rest primarily with the host authority, given the linkages to local practices and regulations established, inter alia, for monetary control. Nevertheless, the home authorities were also deemed to have an important role to play. This was particularly the case for foreign branches that are subject to minimal restrictions for depositing and withdrawing funds with their parent banks. In effect, it was judged that liquidity of a branch could not be judged in isolation from that of the parent bank. While the legal linkages are different in the case of subsidiaries and joint ventures, the Concordat noted that supervision by the home authority was necessary given the scope for stand-by credit facilities and "moral responsibilities" of the parent

1/ The Committee, whose name was later changed to the Basle Committee on Banking Supervision, was formed in 1974 by the central bank governors of the G-10 countries. Its objective is to strengthen cooperation among national regulatory and supervisory authorities.

2/ Details are contained in Basle Committee on Banking Regulation and Supervisory Practices (1975).

3/ The third element addressed by the Concordat--that of foreign exchange transactions--is not covered in this paper.

institutions for the obligations of their subsidiaries. Similar considerations were raised with relation to solvency. Thus, while host countries were seen as having primary responsibilities in the case of subsidiaries and joint ventures, home supervision was also important to take account of parent banks' "moral commitments" to their foreign affiliates. Home supervision was emphasized more in the case of branches as their solvency is legally indistinguishable from that of the parent bank as a whole.

2. The 1983 revisions to the Basle Concordat

The text of the Basle Concordat was revised in September 1983 to take account of the subsequent acceptance by the G-10 Governors of the principle of consolidation. 1/ The revised Concordat stressed that the consolidated examination of the totality of a bank's business worldwide was a critical aspect in arriving at a judgment about the soundness of the bank. It emphasized that the principle of consolidation required that the home regulatory authority monitor the risk exposure of internationally active banking groups on the basis of all of their business activities wherever these may be conducted. Consolidation was seen to complement host- and home-country responsibilities identified in the 1975 principles. Thus, the revised Concordat supplemented the guidelines for the sharing of responsibilities by placing additional responsibility on the home authorities from a consolidation viewpoint. In the case of solvency issues, the revised text emphasized that the home authority needed to assess whether the parent institutions' solvency was being affected by the operations of their foreign affiliates. As regards liquidity aspects, and notwithstanding the practical difficulties imposed by differences in local regulations and market conditions, the revised draft noted that home authorities have a general responsibility for overseeing the liquidity control system of the banking group as a whole and should consult with host authorities to ensure that the latter were aware of the overall systems within which the foreign establishments were operating.

The Basle Committee recognized that there may be cases where some national regulatory and supervisory practices may prove inadequate within this framework. Four types of problems were identified--some of which proved to be of relevance in the BCCI case. The first arises from inadequate host authority supervision. In such circumstances, the Committee recommended that the home authority should either extend its supervision, to the degree possible, or simply constrain the parent bank from continuing to operate the establishment in question. 2/ For the second type, related to inadequate home supervision, the Committee recommended that the host authority should prohibit the operation in its jurisdiction of such foreign establishments; alternatively, the host authority could impose specific conditions governing the conduct of these banks. The third group of

1/ Basle Committee on Banking Regulations and Supervision Practices (1983).

2/ Bank for International Settlements (1983).

problems related to regulatory and supervisory gaps arising out of structural features of international banks. The Committee identified the specific case of the holding company structure which, as discussed below, was a key feature of the BCCI set-up. The Committee argued that in cases of banking groups involving establishments incorporated in different jurisdictions and organized under a holding company, the authorities responsible for supervising those banks should coordinate their supervisory activities, taking into account the overall structure of the group. Finally, it was acknowledged that since the implementation of consolidated supervision presupposes that the home authority has access to all relevant information about the operations of the foreign establishments, problems may arise with existing banking secrecy provisions in some financial centers.

3. Implementation of the Concordat

In collaboration with the Offshore Group of Banking Supervisors, the Basle Committee circulated in 1987 to bank supervisors worldwide, recommendations for "practical international collaboration" between banking supervisory authorities, based on the revised Concordat. 1/ These recommendations were drawn from a joint report discussed at the 1986 ICBS and supplemented the text of the revised Concordat. 2/ They were designed to encourage more regular and structured collaboration between supervisors, with a view to improving the quality and coverage of the supervision of cross-border banking. These recommendations included:

(i) Using the procedure for authorizing the establishment of foreign presence as a basic instrument for preventing the establishment of banking operations of "dubious merit." In this regard, the Committee stressed that host authorities should exercise particular care in approving applications for banking licenses from foreign entities not subject to prudential supervision in the home country. It noted that, in such cases, the authorization by the host authority should be provided only if it was in a position to exercise a parental role.

(ii) The provision by home authorities to host authorities of information regarding significant matters affecting a parent bank or head office. The principal requirement in this area was identified as the establishment by the home authorities of clear channels for the regular flow of information from foreign affiliates to the parent bank and, in a consolidated form, to the home authorities.

(iii) Exchange of information in the opposite direction, including in the form of the host authorities providing information on problems in the foreign entity with regard to management competence or the bank's reputation in the market.

1/ The recommendations are presented in Basle Committee on Banking Supervision (1990).

2/ The report is reproduced in Basle Committee on Banking Regulations and Supervisory Practices (1986).

(iv) Removal of secrecy constraints to enable the exchange of information among national authorities, with the understanding that the information received would be used solely for purposes related to the prudential supervision of financial institutions.

(v) Ensuring thorough and reliable auditing of foreign establishments by external auditors.

These recommendations were endorsed by the 27 national supervisory authorities represented on the Basle Committee and on the Offshore Group of Banking Supervisors. Moreover, indications were received from other countries which, on the whole, pointed to no intractable problems in implementing the recommendations. 1/

III. The Evolution of BCCI

The review of the multilateral framework for the regulation and supervision of international banks provides the context for the analysis of some of the key issues raised by the BCCI case. To this end, the following discussion outlines the evolution of the bank, thereby setting the stage for the next section's consideration of related regulatory and supervisory issues.

BCCI, founded in 1972, was registered in Luxembourg with branches in London, Luxembourg, and Abu Dhabi. BCCI subsequently adopted a multi-bank structure under the parent holding company--BCCI Holdings S.A.--which was chartered and headquartered in Luxembourg. The two primary banking arms of the company--BCCI S.A. and BCCI (Overseas) Limited--were chartered in Luxembourg and the Cayman Islands, with the operational headquarter based in London.

The initial phase of BCCI's expansion was focussed on retail and trade financing activities in the Middle East and the United Kingdom. This was followed by an expansion into other parts of Asia, Africa, and the Caribbean. BCCI's growth was substantial by all measures. During the first five years, its reported assets grew from US\$200 million to over US\$2.2 billion. 2/ Reported profits rose from US\$0.3 million in its first year of operation to US\$26 million in the fifth year. Its branch network also increased sharply; by the end of its fifth year of operation, BCCI had 146 branches in 32 countries. By the late 1980s, the bank was among the ten

1/ Basle Committee on Banking Regulations and Supervisory Practices (1988).

2/ A summary chronology of BCCI's foundation and expansion may be found in Timewell (1991).

largest in the world, operating through over 400 branches in over 70 countries, with some 1.3 million depositors and assets in excess of US\$20 billion. 1/

The rapid initial growth of BCCI's balance sheet reflected a number of factors. At an early stage of the bank's existence--i.e., after the 1973/74 oil price increases--several Middle Eastern countries benefitted from large oil revenue windfalls. BCCI was in a unique position to attract related business given its relatively widespread network in these countries, as well as in industrial countries where a significant portion of the revenues were directed. Moreover, the windfalls strengthened the financial conditions of some of the bank's shareholders, facilitating their support for expanding the bank's capital base. The association with Bank of America (BoA)--one of the initial shareholders--helped BCCI's international acceptance and provided access to BoA's global network and correspondent banking relations. 2/ Finally, BCCI hired experienced managerial staff from several other banks. 3/

A number of financial problems came to the fore in the late 1980s. The bank experienced a sharp decline in profits after 1984; reported profits fell from US\$363 million in 1984 to US\$38 million in 1987. Losses of US\$49 million were reported for 1988. 4/ The deterioration in the bank's position was due, in significant part, to sustained foreign exchange dealing losses estimated to have totaled some US\$600-700 million (excluding interest) in 1977-85. 5/ Reflecting its financial difficulties, the bank moved in 1989 to place a US\$75 million rights issue and raised US\$106 million through subordinated capital notes. In May 1990, the bank reported losses of about US\$500 million for 1989. Simultaneously, it announced the launching of a restructuring program along with a recapitalization of some US\$400 million, increasing capital funds to US\$1.5 billion. The restructuring included the closure of 17 branches and a cutback of some 4,000 jobs. There were also plans for some important changes in the structure of the banking group, steps that were encouraged by bank supervisors. 6/ Specifically, the group's operational headquarters was to be moved from the U.K. to the U.A.E., where the majority shareholder was located. This was to be followed by the formation of three new and separate banks to be based in the U.K., the U.A.E., and Hong Kong.

1/ The consolidated financial statement of BCCI Holdings (Luxembourg) reported total assets of US\$23.5 billion on December 31, 1989. By that time, BCCI S.A. had branches in 13 countries (including 24 in the United Kingdom) and subsidiaries in Canada and Gibraltar. BCCI Overseas had branches in 28 other countries. Finally, 29 subsidiaries and affiliates in 28 other countries came directly under the holding company.

2/ Bank of America sold its share holdings in the early 1980s.

3/ Additional information is contained in Elley (1983).

4/ BCCI made loan-loss provisions of some US\$750 million in 1988-89. Further information is contained in Chowdhury (1990) and Whiteside (1991).

5/ See Timewell (1991).

6/ Hall (1991 b).

Supervisors' support for the above-cited changes in BCCI's structure reflected concerns at evidence of irregularities within certain parts of the banking group. Thus, during the late 1980s and early 1990s, BCCI was subject to several legal actions. In October 1988, U.S. federal prosecutors in Florida charged BCCI Holdings and its two principal banking subsidiaries with conspiracy to defraud the Internal Revenue Service and with money laundering. A "cease and desist" order was issued by the Federal Reserve in June 1989 against these entities requiring them to strengthen their internal controls over all their U.S. operations. In February 1990, BCCI pleaded guilty in Florida to charges that it had laundered US\$14 million and agreed to fines to that amount. BCCI was also involved in various legal proceedings in other countries including Brazil, Colombia, India, Kenya, Mauritius, and Sudan. In early 1991, BCCI was reported to have inappropriately acquired a controlling stake in a U.S. bank (First American Bankshares Corporation). 1/

The catalyst to the July 1991 worldwide closure was the finding of a June report by auditor Price Waterhouse, commissioned by the Bank of England in March under Section 41(1) of the Banking Act (1987). According to the papers filed by the Bank of England in the U.K. High Court, the report pointed to large-scale fraud going back several years. This included the misrecording of deposits, the concealment of losses on loan and treasury operations, the making of fictitious loans, the use of fictitious accounts and of existing accounts without the permission of account holders, and concealment from regulatory authorities of the bank's true financial position. 2/ With the support of this evidence, regulatory authorities in several countries took steps on July 5, 1991 to secure control of the assets of banks in the BCCI group. Coordinated action, in the form of seizing the group's assets and closing the branches, was taken in the jurisdictions with the largest operations (including Cayman Islands, France, Luxembourg, Spain,

1/ See Mattingly (1991). BCCI had also operated agencies in the United States licensed by the states of California, Florida, and New York. Given the legal restrictions on agency operations, these entities were not able to offer insured deposits of any kind. The Florida agency was closed in January 1990 after refusal by the Florida Comptroller of Banks to renew the license. The San Francisco office was closed voluntarily; the remaining offices in New York and Los Angeles were closed by end-1991 under a Federal Reserve cease and desist order.

2/ Additional information is contained in Timewell (1991).

Switzerland, and the United Kingdom). This was followed by similar actions in some 60 other countries. Moreover, several regulatory authorities subsequently issued indictments against the bank and its senior officers. 1/

IV. Regulatory and Supervisory Issues

BCCI's operations have raised a number of regulatory and supervisory issues, some of which came to the fore well before the 1991 worldwide closure. Thus, recognition of the risks inherent within the BCCI's structure, which pre-dated the revision of the Basle Concordat, was a key factor in the Federal Reserve's decision to reject BCCI's application for establishing a bank in the United States in the early 1980s. 2/

Awareness of possible problems with respect to the existing operations of BCCI entities led to the establishment in 1987 of a "college of supervisors." This multilateral coordination framework--formed by the Luxembourg authorities and including representatives from the Cayman Islands, Hong Kong, the United Kingdom, and the United States--was basically aimed at proxving the functions of a single authority responsible for the consolidated supervision of BCCI's multifarious organization. The college required, on occasion, reports from external auditors on areas of particular concern. 3/ It also sought to coordinate multilateral responses to avoid contagion from one arm of the banking structure to other parts. Thus, it provided a forum for consultations among regulatory authorities prior to the 1988 Florida indictment with a view, inter alia, to discussing the potential ramification of the U.S. action on BCCI's operations in the United Kingdom, the Cayman Islands, Hong Kong, and Luxembourg.

1/ The actions taken by the United States are summarized in Mattingly and Taylor (1991). The worldwide liquidation of BCCI was effectively initiated in early January 1992 by the winding up by the Luxembourg district court of BCCI SA. The Luxembourg action, which was taken within the specified six-months period from the July 5 action to place the bank under "controlled administration," was followed by similar actions in other jurisdictions.

2/ John Heimann, bank supervisor at the New York Federal Reserve at the time of this application, noted that "the New York Banking Department, which had jurisdiction, refused BCCI entry because it firmly believes that no foreign bank should be permitted to operate in the state unless it had a home-country supervisor to whom the department could turn for information. A primary supervisor is so important because it has the responsibility--and the power--to know everything, good or bad, and to take a consolidated view of the bank, regardless of the scale of its international operations." Heimann (1991).

3/ See Taylor (1991).

Notwithstanding the above, however, BCCI's structure appears to have exploited several gaps in the consolidated regulation and supervision of internationally active banks--even taking into account the recognized difficulties regulators face in detecting fraud. 1/ Three major gaps may be identified. First, since Luxembourg law does not subject holding companies to supervision, BCCI appears to have avoided consolidated home-country supervision of all its international activities. 2/ Second, the adoption of a dual banking structure, in the form of the two principal subsidiaries in Luxembourg and the Cayman Islands, led to a splitting of lead regulatory responsibilities among the jurisdictions. Third, the transmittal of information about the financial condition of the parent banking institution may also have been inhibited by the secrecy rules that applied in some supervisory jurisdictions.

Overall, therefore, BCCI was neither subject to effective consolidated home supervision nor were host supervisory authorities in a position to proxy such a function given incomplete information flows. While the formation of the college of supervisors allowed some of the weaknesses to be addressed, it was only partially effective in dealing with those problems intrinsic to the structure of the banking group.

It is in this context that the BCCI episode has induced policy reviews at the national and multilateral levels aimed at strengthening the regulation and supervision of foreign banks. 3/ These reviews have taken on an added sense of importance in the context of the European-wide move toward the common passport principle under the EC Second Banking Directive. The key policy challenge lies in improving the regulatory and supervisory structure without imposing excessive anti-competitive compliance costs on the banks. Two types of regulatory responses have been considered. The first, already reflected in national policy adaptations, involves changes in regulatory procedures by providing additional cases where host-country supervision may supersede home supervision. The second approach seeks to strengthen the application of the common passport principle through improved designation procedures and greater financial incentives to induce more effective home supervision.

1/ The paper does not deal with the specifics of the reported fraudulent activities, some of which are discussed in Financial Times (1991).

2/ It may also be noted that the holding company had no formal access to a lender of last resort facility in its home country. As for banking activities located in the principality, the authorities did request liquidity protection in the form of "letters of comfort" from the major shareholders of BCCI.

3/ In addition to the changes discussed below, the BCCI experience has also reportedly acted as a catalyst to changes in Luxembourg where the holding company and one of the banking subsidiaries were chartered but did not conduct banking business there. Thus, the Luxembourg authorities have indicated that they will no longer license a bank or a bank holding company that does not conduct business in that country.

The recent legislative actions in the United States provide an example of the first type of regulatory adaptation. The "Foreign Bank Supervision Act," passed in November 1991, incorporates several measures aimed at strengthening the regulation and supervision of foreign banking activities in the United States. Thus, the Act requires that the Federal Reserve certify that the home supervision of foreign banks operating in the United States is adequate; this is likely to involve a judgment regarding the application of the same financial, managerial, and operational standards that govern U.S. banks. 1/ The Federal Reserve and Treasury are to consult as to the capital adequacy of foreign banks seeking to establish U.S.-based operations. The Act also requires that the new retail operations of such banks be conducted in separately capitalized subsidiaries rather than branches. 2/ In addition, the Act seeks to provide regulators with the information-gathering tools necessary to carry out their responsibilities. Thus, foreign banks would agree to supply information on their activities and operations that U.S. regulatory agencies find to be necessary to determine whether the banks are in compliance with U.S. banking requirements.

In addition to preventing the establishment or acquisition of the control of a bank by foreign entities with no consolidated supervision abroad, U.S. regulators now have the power to eject these entities later on for the same reason. Specifically, the Act grants regulators the power to discontinue the operations of a foreign bank if they become dissatisfied with its supervisory structure. This goes well beyond the situation in the EC where, under the Second Banking Directive, most countries will be empowered to halt the operations of bank branches locally if such operations are in breach of criminal laws. Finally, the strengthening of the U.S. regulatory and supervisory framework is accompanied by the imposition of uniformity among individual states in the approach to foreign institutions.

The above approach has been seen in some quarters as possibly involving interference with the application of the home-country/common passport principle--a principle that, as noted in Section II, has been at the center of the multilateral efforts. Indeed, the approach highlights one of the basic difficulties facing the implementation of this principle--how to limit the risk of regulatory oversights in foreign jurisdictions pending the attainment of an appropriate "common denominator" among countries that currently differ in their degree of regulation and supervision. While the approach has the potential of inducing appropriate adjustments in other jurisdictions--thereby contributing to faster progress toward an appropriate

1/ Further discussion is contained in Mattingly (1991).

2/ The Act also requires that several U.S. government agencies carry out a study assessing the merits of requiring that all the operations of foreign banks be conducted in separately capitalized subsidiaries. If these studies are unanimous in their recommendations, the Act authorizes the Federal Reserve to implement such a requirement without need for new legislation.

common denominator--there is also the risk that it may undermine multilateral understandings on the financial liberalization process underpinned by the concept of consolidated home regulation and supervision based on a harmonized set of rules and procedures.

The move toward greater host-country regulation and supervision may be compared to the second type of approach which seeks to modify the application of the home-country principle. This approach is apparent in several proposals being considered by the EC in the context of work on the single financial market. An example is the proposal to strengthen the spirit of the home-country emphasis by basing the designation procedure on the main place of business rather than the country of incorporation. A second proposal involves augmenting financial incentives for adequate home supervision. Thus, consideration is being given to requiring insurance deposit losses incurred in foreign banks to be met by the home country's deposit protection scheme. 1/ An important step in the implementation of such an approach will be progress in harmonizing deposit insurance schemes in EC member countries.

The above proposals for regulatory adaptations are being accompanied by deliberations at the multilateral level which would seek to improve implementation of the international framework for regulation and supervision. Specifically, the Basle Committee is reviewing the policy implications of the BCCI episode and various measures are under consideration for strengthening the existing procedures. These include interim steps to ensure that banks have a primary regulator in a country that meets certain minimum standards of regulatory adequacy. Under this approach, the college of supervisors could be supplemented by the designation as lead-regulators/supervisors authorities in countries judged to possess adequate regulatory and supervisory structures. The role of such lead-authorities would be supported by legally requiring other countries to provide them with information on, and access to, bank affiliates located in other jurisdictions.

Consideration could also be given to providing greater weight to market signals in the process of bank supervision. As noted earlier, an interesting aspect of the BCCI case is that major financial institutions had only very limited interbank exposures to BCCI. This, in turn, is reported to have reflected in part these institutions' perceptions of the high risks inherent in BCCI's operations. Clearly, such market signals can provide important indicators to supervisors concerned with the integrity of their banking system, thereby supplementing their own set of assessment factors.

1/ Hall (1991 b).

V. Concluding Remarks

The growth of banks with worldwide operations is an important aspect of the ongoing process of financial market globalization and integration. It provides for important efficiency gains in mobilizing and allocating savings at both the national and international levels. The process will be further enhanced by the growing application of the common passport principle which provides banks with the possibility to branch abroad primarily on the basis of consolidated home-country regulation and supervision. At the same time, however, it raises an array of challenges for regulatory and supervisory authorities concerned with maintaining the soundness of their banking systems. The fundamental difficulty facing these authorities is how to assess and contain the risks associated with banks' worldwide operations while avoiding over-regulation that would increase the transaction costs of global banking operations and limit the efficiency gains resulting from the overall process.

The BCCI case has focussed attention on the importance of comprehensive consolidated supervision of internationally active banks. The analysis in the paper suggests that BCCI's structure was such as to result in several regulatory and supervisory gaps. Specifically, because of its holding company organization, BCCI was not subject to consolidated home supervision of all its international activities. Moreover, the adoption of a multi-bank structure led to the splitting of lead regulatory responsibilities among different jurisdictions. Finally, the transmittal of information to and between authorities in different host countries may have been adversely affected by secrecy rules, particularly in "offshore" jurisdictions. In sum, BCCI was not subject to consolidated regulation and supervision by the home authorities and, at the same time, the ability of host authorities to proxy this role was undermined by, inter alia, incomplete information flows and fragmentation of lead regulatory responsibilities.

Analysis of the prevailing international regulatory and supervisory framework suggests that these gaps resulted primarily from the incomplete application of such a framework, rather than from its design. Thus, if applied in a comprehensive manner to all banks with worldwide operations, the framework provides a structure that would address the principal problems demonstrated by the BCCI case. Its effectiveness could be reinforced by measures to increase financial incentives for adequate home supervision, as well as greater use of market signals in the process of bank supervision.

Pending the attainment of a satisfactory common denominator among regulatory and supervisory systems in different jurisdictions, there is likely to be increased country-specific pressures for measures that contain the risks associated with regulatory and supervisory arbitrage. Two major trends may be identified. The first entails strengthening the host country's authority over the establishment and discontinuation of branches of foreign banks. The second, which is less pronounced in its potential friction with the common passport principle, involves strengthening the existing framework by ensuring that, where warranted, banks have a primary regulator in a jurisdiction that meets certain minimum standards of

regulatory and supervisory adequacy. The critical challenge facing the authorities in designing appropriate modifications in this interim period is how to reduce the risk of supervisory oversights without undermining progress toward the comprehensive application of a multilateral framework of regulation and supervision of international banking activities.

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