

Supervision of international groups on a consolidated basis¹

Under the applicable legislation, the Banco de España is responsible for the individual supervision of credit institutions authorised in Spain and for the consolidated supervision of groups of credit institutions whose parent entity is Spanish.

In the international sphere, the relationship between the home country of the parent of a banking group and the host country of that parent's subsidiary is governed by the Basel Committee Concordat². The purpose of these documents was, and is, that no bank's (foreign) establishment should be left without effective supervision, and to this end two measures were established: 1) a clear allocation of responsibilities between home-country and host-country supervisors, and 2) close co-operation and information exchange between them.

These principles, contained in current Community legislation³, establish that the home-country supervisor (of the parent) is responsible for conducting the supervision of the group on a consolidated basis (along with, naturally, that of the individual institutions authorised in its jurisdiction), and the host-country supervisor (of the foreign subsidiary) is responsible for the subsidiaries authorised in the host country.

The realisation that greater co-operation will be needed to implement the new solvency rules in large international groups makes it all the more important to establish principles for the effective and efficient supervision of these cross-border groups. In August 2003 the Basel Committee issued high-level principles reaffirming the current division of responsibilities established in the Concordat and recommending greater co-operation between supervisors. The proposal to amend Directive 2000/12 to incorporate the new capital standards retains this assignment of responsibilities also in the European Union (EU), strengthening the role of the authorities responsible for consolidated supervision and the mechanisms for co-operation and information exchange between EU supervisors.

Against this background, a more detailed description is given below of the consolidated supervision of Spanish groups with an international presence, making special mention of their treatment in the framework of the European Single Market.

¹ Report on Banking Supervision in Spain, 2005. Chapter 2.5, pages 100 to 103

² The 1983 Concordat replaced the 1975 version, Principles for the supervision of banks' foreign establishments.

³ Banking Directive 2000/12, which, among others, compiles the earlier Directives 89/646, 92/30 and 95/26.

Consolidated Supervision in the International Setting

The good management practices of international banking groups and the basic principles for consolidated supervision that are set out below are based on the fact that Spanish groups have undertaken their international expansion using a structure of subsidiaries, because of the rationality provided by this approach, in which each of the group entities has its own legal personality and is subject to the respective local jurisdiction.

The Banco de España's Report on Banking Supervision in Spain, 2002 set out the principles for the management of international banking groups that constitute good practice. The main principles are summarised below.

The banking group as a whole should have an adequate overall level of capitalisation. However, in addition there should be an appropriate distribution of own funds within the group, i.e. in proportion to the risk in any given location, so that each bank, including the parent, in each country has an appropriate amount of capital commensurate with its risk and leeway to allow for its growth.

Each credit institution in the group should be able to identify, manage and assess the risks arising in its own business on an individual basis, using the group's common techniques, systems and culture; all, however, without prejudice to the parent applying the appropriate control mechanisms.

The entities composing a group should be transparent in their financial transactions. Regardless of their degree of affiliation, each should have its own capacity to resort to the markets to finance its activity and to separately establish adequate coverage of its risks. Intra-group transactions should always be conducted at arm's-length prices and not be subsidised in either direction. The best way to effectively apply this principle is for the various entities in a banking group to operate directly with the market and thereby improve transparency, which will enable an effective knowledge and rating of the group and of each of its components.

The group and each individual entity should have an effective internal control system in place. The managers of the respective subsidiaries are responsible and accountable for them. The group should be subject to a rigorous and effective internal audit, as should each of its foreign subsidiaries.

That said, under the assignment of responsibilities described above, which has been functioning properly and which the Banco de España supports the role of the home-country supervisor as the consolidated supervisor cannot replace either the important function or the responsibility of the host-country supervisor in respect of the subsidiaries in the group, for the following reasons:

- The host-country authority has the legal prerogative and capacity required to take supervisory and precautionary measures regarding the subsidiaries in the event of contingency or crisis. The parallelism of the authority granting the licence and the authority supervising on an individual basis should be maintained to avoid any confusion or inconsistency between the responsibilities assigned.

- The host-country authority has a better knowledge of the local markets and, due to its proximity, a greater ability to assess the risks of the activity in the country. It also has a more precise knowledge of the laws applying in the jurisdiction, so it can exercise ongoing supervision of the subsidiary in a more knowledgeable manner, with greater capacity for control and with increased effectiveness.
- The current arrangement is fully consistent with the separate legal personality and legal liability to third parties of the subsidiaries in the group.

In its capacity as consolidated supervisor, the home-country authority has the following functions: verification of the consolidated financial statements, which must be prepared using measurement bases, harmonised with those applied by the parent; control of the group's aggregate solvency; and surveillance of internal controls and management systems in all the group.

To carry out these functions, the home-country supervisor needs to obtain from the parent, any required information about the group since this is the natural flow of information between the home-country supervisor and the foreign subsidiaries of international banking groups. The managers of these groups must not be subject to legal or practical constraints or obstacles in gathering knowledge of and assessing the risks located in the subsidiaries.

However, it should not be overlooked that the effectiveness of consolidated supervision depends on the host countries exercising sound supervision that provides assurance as to the subsidiaries' financial position and risks, their solvency and the management and control mechanisms applied.

In the area of supervision of international groups, the basic aim of co-operation between prudential supervisors is, in addition to strengthening international financial stability, to help each authority in complying with its responsibilities, as described above.

Dialogue and co-operation with other supervisors are essential for the effective supervision of groups and convergence towards best supervisory practices. In view of the structure of Spanish groups, at present the most efficient way to achieve this co-operation is through a bilateral relationship between the home-country supervisor and the host-country supervisor, in a framework of transparency and mutual respect, while multilateral relations are more effective for dealing with conceptual matters and general supervisory issues.

Co-operation between the home-country supervisor and the host-country supervisor includes the communication of whatever significant information can realistically help them to perform their respective functions, taking into account their different nature and, in particular, the fact that a consolidated supervisor needs to have unrestricted information on the subsidiaries, and the host-country supervisor, assuming that the subsidiary is adequately capitalised and managed, needs group information that is significant for the subsidiary. The exchange of information between supervisors is without prejudice to dialogue between the latter and the group's managers.

An appropriate way of crystallising the principles and objectives of co-operation is through cooperation agreements, although there are also other less formal ways, depending on the importance of the subsidiaries. Memoranda of Understanding, apart from providing for the exchange of information, may envisage other types of co-operation, such as the possibility that, in

exceptional cases, the home-country supervisor may, by agreement with the host-country supervisor, perform inspection of the subsidiary.

Consolidated Supervision in the European Union

The basic principles described in the preceding section for transnational banking groups and for organising their supervision are valid in the European Union, with some sharpening. The existence of a common legal basis and of progressively more integrated markets means that the EU, which follows the aforementioned basic assignment of responsibilities, currently has certain mechanisms of enhanced co-operation and plans to strengthen the role of consolidated supervisor.

In this respect, the draft amendment of Directive 2000/12 provides that the consolidated supervisor shall carry out co-ordination tasks in the supervision of the group and in the gathering and distribution of information, and particularly enhances its role in the validation of advanced models in the framework of the new solvency rules. The Committee of European Banking Supervisors (CEBS) is preparing principles of practical co-operation to give content to the Directive and facilitate and improve the consistency of its implementation.