

Credit institutions' policy on international expansion through off-shore establishments¹

In the recent past, the international expansion of Spanish banking groups has become very important in quantitative terms. In this process, the principles and criteria included in the framework of good practice published by the Banco de España in the Report on Banking Supervision in Spain, 2001 have been implemented.

This framework addressed the need to establish a group culture, to apply prudent criteria in relation to consolidation and the amortisation of goodwill, to distribute own funds so that they are in proportion to the risk in each location, and for each subsidiary to have the capacity and autonomy to manage its own risks and to obtain on the market the necessary financing to carry on its activity.

Now is an opportune moment to complete this framework with some reflections on the possible reputational risks that institutions may incur when strategically defining the content, location and form of their activities. Reputational risk is not a watertight concept that depends only on the nature of the operations; rather it evolves over time in step with market perceptions and with the demands and expectations of citizens.

The banking model that Spanish credit institutions have preferred to adopt, both in Spain and, in the case of groups that have undertaken a process of international expansion, in other countries, is that of commercial banking. The experience of Spanish institutions in this area, their capacity to compete and the application of professional and prudent criteria for managing this business model, is the basis of the good health of the Spanish banking system, which is characterised by its favourable levels of solvency, profitability and efficiency, as confirmed by the analysis in Chapter I of this Report.

In accordance with this model, the strategy of Spanish credit institutions does not generally extend to the performance of activities in off-shore centres, but in some cases they have branches or subsidiaries in these territories, with various objectives: to perform private banking activities (mostly with non-residents in the country), to carry out securities issuance or in the odd case to carry out commercial banking activities. In many cases these are situations inherited by Spanish institutions when purchasing banking subsidiaries abroad which themselves have subsidiaries or branches in off-shore territories. However, in relative terms, only securities issuance in these territories represents a significant percentage of the total activity of the sector.

The term "off-shore financial centre" is not easy to define precisely, but it basically refers to territories that attract a significant volume of activity from non-residents by reason of the fact that some of the following circumstances obtain: banking licences can be readily obtained, supervision is less developed, it is possible to operate either without any or with a minimal physical presence, there are special bank secrecy rules, tax advantages exist, special purpose vehicles can be easily established and the legal treatment of residents and non-residents is different.

¹ REPORT ON BANKING SUPRVISION IN SPAIN 2003. Chap. II.5, pages 101 to 103.

In order to minimise the legal and reputational risks that may be incurred by off-shore establishments, to guarantee effective and prudent management thereof by the group, to ensure effective supervision and to anticipate possible damage to Spanish credit institutions that may arise even if their management is orthodox, the Banco de España considers that groups of Spanish credit institutions with off-shore establishments should comply with the following principles:

1 Maximum involvement of the parent bank's administration bodies

The board of directors of the parent institution shall constantly assess the need to operate in the various geographical areas in which the group carries on activity (including off-shore centres), identify and measure the legal and reputational risks incurred (which are not eliminated merely by the existence of orthodox banking management and good customer knowledge procedures), and continuously assess whether the return to the group from its activities justifies the level of risk assumed.

The board of directors shall also expressly assume the responsibility of maintaining each establishment abroad. For this purpose it shall define specific policies for investment in these centres, the type of activities that are to be carried out, the limits applicable, the measures that must be adopted to mitigate reputational and legal risks, the checks to be made on the various risks incurred and the information that must be available. Its involvement should extend to special monitoring of the activities performed, for which purpose it should obtain regular and detailed information on such activities, and their associated problems and risks.

The audit committee of the parent institution shall be required to supervise the internal control of off-shore activities and to prepare an annual report for the board thereon.

2 Clear identification of the activities of each offshore establishment

The objects of the establishment and the activities that can be carried out in an off-shore centre must be clearly identified and defined.

Where the activity of the off-shore establishment consists of serving as a special vehicle for a specific purpose (securities issuance, etc.), use of the same vehicle for different activities should be avoided and the funds raised should not be accumulated at the off-shore establishment itself, but should be located at the on-shore entities of the group that issue the guarantee to enable them to be raised.

If the activity pursued is private banking, the board of directors shall include in the definition of its corresponding policies specific criteria on direct or indirect investment of customer funds in assets eligible as own funds or other assets issued by the group. Also, off-shore establishments that may constitute fiduciary deposits in Spanish institutions shall supply to the parent institution precise and documented identification of the end customer, which must be kept available for the Spanish authorities.

3 Effective control by the parent of the banking group over off-shore activities

For the purposes of effective control by the group and to enable management decisions to be taken, the central offices of the parent institution should have regular and detailed information on the activities of the establishment and its risks. And this information should be available to the BE for supervisory purposes.

The parent institution's internal control systems should extend to the activity of off-shore establishments. In particular, the internal audit department should draw up definite plans for inspection visits and issue reports at least once a year. Their work programmes shall include, inter alia, checking that the operations carried out come within the establishment's objects, reviewing the application of the policy for the prevention of money laundering, the requirements relating to customer knowledge, Spanish law applicable to transfers of funds between Spain and other countries, and the accuracy of the information sent to the parent institution. The reports shall analyse and assess the reputational and legal risks of the activity, including that with customers

resident in Spain. All the information relating to the procedures and controls established shall be available to the Banco de España.

The group shall have a legal compliance officer, whose responsibilities shall extend to the activities carried out in all countries, and who shall prepare, at least once a year, a report to the board, setting out conclusions on the degree of compliance with legal provisions and the internal rules of each external establishment, and on the level of the legal and reputational risks incurred.

In order to avoid the Spanish banking system being used to channel illegal transactions, it is essential that the group's overall policy for the prevention of money laundering and for compliance with customer-knowledge requirements be applied in off-shore centres as strictly as in Spain.

Finally, it must be ensured, insofar as this is possible, that the firm of external auditors of the off-shore establishment is the same as that of the Spanish parent institution and the consolidated accounts of the banking group.

4 Transparency in the annual accounts

Groups shall give detailed information in their annual reports on the activities carried out by each off-shore establishment, including their nature, their volume, their risks and the mechanisms established to control them.

Institutions that substantiate the need for subsidiaries or branches in off-shore centres shall have a clearly defined strategy with respect to the establishment and its activities, and ensure that the principles set out above are complied with at all times.