Core Principles for Effective Banking Supervision

Global Workshop on Implementing
Emerging Financial Sector Standards
A Public/Private Sector Challenge

The Basel Committee Core Principles for
Effective Banking Supervision

18-19 December 2000

Danièle Nouy
Secretary General of the Basel Committee

Core Principles for Effective Banking Supervision

Outline

1. Basel Committee on Banking Supervision,
2. Core Principles for Effective Banking Supervision,
3. Process,
4. Content,
5. Implementation: methodology and current issues.

Core Principles for Effective Banking Supervision

1. A few general points on the Basel Committee

- It was created in 1974 by the Committee of G-10 Governors and is comprised of banking supervisory authorities of the G-10 countries,
- It meets at least four times a year and conducts every two years a worldwide supervisory conference (ICBS),
- It has a Secretariat hosted by the BIS, and several working groups (some temporary, some more permanent).

Core Principles for Effective Banking Supervision

The Basel Committee:

1. Is first of all a rule-maker institution (enforcement relies with IMF, World Bank and national authorities), producing three categories of rules/documents:
   - Binding minimum standards,
   - Best supervisory practices papers,
   - And, more recently, the Core Principles for Effective Banking Supervision.
2. Is a forum for cooperation between bank supervisors inside and outside G-10 countries and with other fellow supervisory groups (IOSCO, IAIS, IASC, etc.).

2. What are the Core Principles?

- A set of supervisory guidelines aimed at providing a general framework for effective banking supervision;
- A reference document for the use of national supervisors and international institutions.

Core Principles for Effective Banking Supervision

They are:

- The first truly joint G-10/non-G-10 product,
- The first comprehensive document dealing with banking supervision,
- A significant political statement,

…. but still only one step in a continuous process by the world supervisory community.

Core Principles for Effective Banking Supervision

But the Core Principles are not:

- A “quick fix”,
- A remedy for economic mismanagement,
- A guarantee that no bank will fail,
- A rigid set of standards.

3. Process / History

- Issued in September 1997.
- Completed in May 1999 by the Methodology for assessing compliance with the Core Principles.
- Reviewed during a May 2000 workshop aiming at:
  - sharing experiences between the parties involved (IMF, World Bank, Basel Committee, national supervisors assessed, assessors, etc.),
  - exploring a possible need for revision (of the Core Principles themselves or the Methodology).

4. Content

Section I:	Introduction
Section II:	Preconditions for effective banking supervision
Section III:	Licensing process and approval for changes in structure
Section IV:	Arrangements for ongoing banking supervision
Section V:	Formal powers of supervisors
Section VI:	Cross-border banking
Appendix I:	Special issues related to government-owned banks
Appendix II:	Deposit protection

Core Principles for Effective Banking Supervision

Introduction (Section 1):

- "Effective supervision of banking organisations is an essential component of a strong economic environment. The task of supervision is to ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business."

- "While the cost of banking supervision is indeed high, the cost of poor supervision has proved to be even higher."

Preconditions for Effective Banking Supervision (Section II):

- "There are certain infrastructure elements that are required to support effective supervision. Where such elements do not exist, supervisors should seek to persuade governments to put them in place (and may have a role in designing and developing them)."

Core Principles for Effective Banking Supervision

These preconditions for Effective Banking Supervision are:

1. Sound and sustainable macro-economic policies,
2. A well-developed public infrastructure,
3. An effective market discipline,
4. Procedures for efficient resolution of problems in banks,
5. Mechanisms for providing an appropriate level of systemic protection (or public safety net).

Core Principles for Effective Banking Supervision

Principle 1:

- An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Components necessary to support Principle 1

- A consistent framework of responsibilities and objectives with operational independence to pursue them free from political pressure,
- Adequate resources,
- A framework of banking laws that gives supervisors the powers to carry out their duties and enforce penalties if necessary,
- Protection from personal and institutional liability for supervisory actions,
- The ability to share information with other regulators, domestic and international, and to protect the confidentiality of that information passed or received.

Licensing Process and Approval for Changes in Structure (Section III)
Principles 2 to 5

- "Although the licensing process cannot guarantee that a bank will be well run after it opens, it can be an effective method for reducing the number of unstable institutions that enter the banking system."

- "Clear and objective criteria reduce the potential for political interference in the licensing process."

Licensing Process

1. the proposed ownership structure,
2. the operating plan, systems of control and internal organisation,
3. suitability of directors and senior managers (fit and proper test),
4. financial projections including capital.

There should also be prior approval from the home country supervisor when the proposed owner is a foreign bank.

Licensing Process (continued)

Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

They must also have the authority to establish criteria for reviewing major acquisitions or investments by a bank.

Arrangements for Ongoing Banking Supervision (Section IV)

This section contains 16 of the 25 principles and covers the essence of ongoing supervision. The principles are arranged in three sections:

- Prudential regulation and requirements

  Principles 6 through 15

- Methods of ongoing banking supervision

  Principles 16 through 20

- Information requirements

  Principle 21

Core Principles for Effective Banking Supervision

Main prudential Regulations and Requirements:

- Capital adequacy,
- Credit risk management,
- Market risk management,
- “Other” risk management,
- Internal controls.

Methods of Ongoing Banking Supervision:

- On-site and off-site supervision,
- Regular contact with bank management,
- Means of collecting, reviewing and analysing prudential reports and statistical returns on a solo and consolidated basis,
- Means of independent validation,
- Ability of supervisors to supervise consolidated entity.

Core Principles for Effective Banking Supervision

Information Requirements

Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

- Accounting standards
- Scope and frequency of reporting
- Confirmation of the accuracy of information submitted
- Confidentiality of supervisors' information
- Disclosure

Formal Powers of Supervisors (Section V)

- "***Supervision cannot, and should not, provide an assurance that banks will not fail (the possible "expectation gap" that could generate moral hazard).*** In a market economy, failures are a part of risk-taking. The way in which failures are handled, and their costs borne, is in large part a political matter involving decisions on whether, and the extent to which, public funds should be committed to supporting the banking system. Such matters cannot therefore always be entirely the responsibility of banking supervisors; however, supervisors should have in place adequate arrangements for resolving problem bank situations."

Formal Powers of Supervisors (Continued)

Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements, when there are regulatory violations, or where depositors are threatened in any other way:

- Mild corrective measures (e.g. extra reporting, tighter limits, special audits),
- More punitive measures (e.g. fines, replacement of managers, suspension of dividends,
- Revocation of license ("nuclear weapon").

Cross-border Banking (Section VI)

- Obligations of home country supervisors
- Obligations of host country supervisors

Based on concepts contained in the Basel Concordat and the document “The supervision of cross-border banking”. (See as well the June document of the Basle Committee on Cross-border supervisory cooperation on Year 2000 issues).

5. Implementation

The challenge for supervisors is QUALITY implementation of the Core Principles. It involves two key points:

- Exemplary cooperation between the standard setter: the BC, and the actors of the implementation process: IMF, WB and the countries involved.
- Ongoing monitoring of the implementation process.

The methodology for assessing compliance with the Core Principles

- Why such a methodology? In order for the assessments to be as uniform as possible.

- How is it structured?

  - **Chapter 1**: background to the Core Principles,
  - **Chapter 2**: conduct of an assessment and compilation and presentation of results,
  - **Chapter 3**: discussion of each core principle, and of the "**essential criteria**" and **"additional criteria"** relevant for compliance,
  - **Annex**: Template IMF - World Bank assessment report.

How does the Basel Committee support the implementation process?

- **Core Principles Liaison Group**;
- **Further research**: Methodology for assessments, Implementation guidance (glossary of terms, identification of good / best practices, alternative solutions when full compliance with a principle is not immediately possible, etc);
- **Workshops/Fora** for cooperation between all the parties involved.

Core Principles for Effective Banking Supervision

In many countries quality implementation is a challenging process, as it requires:

- Adequate overall infrastructure, including accounting, reporting and disclosure requirements that support financial transparency,
- A banking regulatory framework that supports sound banking practices,
- A trained and motivated body of professional supervisors.

Core Principles for Effective Banking Supervision

The necessary steps for quality implementation:

1. A fair assessment of the situation (through self-assessments, “externally assisted self-assessment” or external ones);
2. A calendar for reforms both realistic and ambitious, with the appropriate sequencing;
3. Ongoing cooperation with the community of bank supervisors to learn from each other’s experiences.

Conclusions

- A lot has been done (much more than initially expected, at least for banking supervision),
- …but a lot still to be achieved.
- The most promising: the changes in the supervisory culture.