FINANCIAL STABILITY INSTITUTE

BANK FOR INTERNATIONAL SETTLEMENTS

# The Core Principles for Effective Banking Supervision

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Elizabeth Roberts

Director, FSI

# Importance of Financial Stability

- It is a well recognised fact that unstable financial systems can severely disrupt macro-economic performance in industrial, developing and transition economies
- Widespread and costly banking problems in the last decades of the 20th century prompted concerted efforts on the international level to promote sound and stable financial systems

# Importance of Financial Stability

- The importance of these efforts is underscored by the ever increasing integration of the banking, insurance and securities sectors
- These efforts are also critical due to the continuing globalisation of financial systems (contagion risk)
- Finally, the increasing complexity of financial instruments and the uncertainty of who actually bears the risk also requires more interaction among supervisory authorities

# Global Standards

- The standard-setting bodies of the financial sector supervisors have been making efforts over the past decade to raise supervisory standards globally
- The Basel Committee, IAIS and IOSCO have all developed principles for a comprehensive framework of supervision and regulation
- These various sets of “core principles” serve as a yardstick to be used by national authorities, as well as the IMF and World Bank, in evaluating the quality of supervision

# Improved Banking Supervision

- The key objective of banking supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors
- In order to maintain confidence in the banking system, supervisors must demonstrate that they have the authority and competence to deal promptly and efficiently with problems at individual institutions

# What are the Core Principles for Effective Banking Supervision?

- The Core Principles are a set of supervisory guidelines or principles aimed at providing a general framework for effective banking supervision. They are intended for G-10 as well as non-G-10 countries
- To be used as a reference document by national supervisors and international institutions
- Contribution of the Basel Committee to the objective of "strengthening supervisory standards in emerging and developing countries”

# What the Core Principles Are Not

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

# The Last Revision Process

- The Basel Committee decided in 2004 that it was time to review and revise both the Core Principles and the Core Principles Methodology
- The documents were seven and five years old, respectively and did not accurately reflect the most recent developments in banking and banking supervision, including Basel II
- Much experience had been gained and issues had arisen from the more than 100 FSAPs conducted to that point
- In addition, the Basel Committee wanted to ensure that, to the extent possible, its Core Principles are consistent with corresponding standards for the securities and insurance sectors

# The Revision Process

- The Committee directed that the changes should be kept to a minimum ("do not keep moving the goal posts")
- There should be a balance between incorporating new practices and maintaining continuity in the framework
- A steering committee was formed to oversee the work of three drafting teams
- The Basel Committee conducted extensive consultation with non-member countries and issued the revised documents for public comment
- The revisions were finalised in mid-2006 and then "ratified" at the International Conference of Banking Supervisors in October 2006

# The Revision Process

- The overall number of Principles remained at 25
- The number of assessment criteria increased from 227 to 245
- Some Principles were merged in order to make room for new ones – specifically related to risk management, as well as interest rate, liquidity and operational risk

# The Current Revision Process – Stay Tuned!

- At its October 2010 meeting, the Basel Committee decided to initiate a second review of the Core Principles, beginning in 2011
- The primary objective of the current review is to reflect in the Principles the lessons learned from the recent financial crisis and the new standards collectively referred to as Basel III
- The Committee expects to complete the revisions by year-end 2011 and issue the revised Core Principles for comment

# The Current Revision Process – Stay Tuned!

- Key areas of review include:
  - Systemically important banks (SIBs)
  - Macroprudential and systemic risk issues
  - Crisis management and resolution
  - Corporate governance
- Some of these issues will be handled in the "preconditions" while others will be covered in the Principles themselves (including 4 new Principles)
- In addition, the CPs have been completely reorganised

# The Core Principles for Effective Banking Supervision – An Overview

# Broad Range of Supervisory Topics

- Supervisory objectives and powers
- Permissible activities
- Licensing process
- Approval for changes in ownership and activities
- Prudential regulations and requirements
- Arrangements for ongoing banking supervision

- This is why they serve as the foundation for an effective supervisory system

# Supervisory Objectives and Powers

- Clear responsibilities and objectives for each agency
- Operational independence, transparent processes, sound governance, adequate resources and accountability for discharge of duties
- A suitable legal framework for bank licensing and ongoing supervision, including determining compliance with laws and addressing safety and soundness concerns
- Legal protection for supervisors
- Arrangements for information-sharing among supervisors

# Permissible Activities

- Controlling the use of the word “bank”
- Defining permissible activities of licensed institutions
- The activity of taking deposits from the public is generally reserved for institutions that are licensed and subject to supervision as banks

# Licensing Process

The licensing process is critical to ensuring that participants in the banking system have the necessary qualifications. 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.

# Licensing Process

Items to consider:

- proposed ownership structure and governance
- suitability of directors and senior managers (fit and proper test)
- strategic and operating plan
- internal controls and risk management
- financial projections, including capital
- for foreign banks, the prior approval of the home country supervisor

# Changes in Ownership and Activities

Supervisors should also monitor significant changes in ownership structure as well as significant changes in activities (including acquisitions and investments).

# Arrangements for Ongoing Banking Supervision

This section contains most of the 25 principles and covers the essence of ongoing supervision. There are two primary components:

- Prudential regulations and requirements
- Arrangements for ongoing banking supervision

# Prudential Regulations and Requirements

- Capital adequacy
- Risk management, including:
  - credit risk (5)
  - market risk
  - liquidity risk
  - operational risk
  - interest rate risk in the banking book
- Internal control and audit
- Protecting against abuse of financial services
- Comprised of Principles 6 through 18

# Prudential Regulations and Requirements

- A major change to this section in the last review was the addition of a separate Principle on risk management:
- “Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.”
- This Principle sets the tone for those that follow on specific risk categories

# Ongoing Banking Supervision

- Supervisory approach – develop and maintain a thorough understanding of the operations of individual banks and the stability of the banking system as a whole
- Supervisory technique, including:
  - a combination of on-site and off-site supervision
  - sufficiently frequent contact with the bank's Board and management
- Supervisory reporting - collecting, reviewing and analysing prudential reports and statistical returns on both a solo and consolidated basis and a means of independent verification (through on-site exams or use of external auditors or other experts)

# Ongoing Banking Supervision

- Accounting and disclosure
  - “adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally”
  - “publication on a regular basis of information that fairly reflects the bank’s financial condition and profitability”
- Corrective and remedial powers of supervisors – need to have an adequate range of measures
- Consolidated supervision
- Home-host relationships
- Comprised of Principles 19 through 25

# The Core Principles for Effective Banking Supervision – Implementation and Assessment

# Challenge = QUALITY Implementation of the Core Principles

- The Core Principles provide the necessary foundation to achieve a sound supervisory system
- Local characteristics need to be taken into account in the specific way in which the Principles are implemented
- The Principles may not be sufficient, on their own, in many countries
- Each country should therefore consider to what extent the Principles need to be supplemented to address particular conditions or risks prevailing in the local market

# Objectives of the IMF/World Bank Core Principles Assessments

- FSAPs, ROSCs
- Determine whether banking supervisors are able to supervise the banking industry in an adequate and effective manner
- Propose a course of action to address identified weaknesses

# Key Elements of the Assessment Process

- Genuine cooperation of supervisory authority is critical
- Assessments must take into account the specifics of each country
- The assessment consists of a combination of off-site and on-site analysis
- Assessment is done Principle by Principle with NO overall assessment or grade given
  - IFIs do not want to become rating agencies
  - Overall assessment can be very political

# Assessment Categories

- Compliant
- Largely compliant
- Materially non-compliant
- Non-compliant
- [Not applicable]

# Report of Findings

- Assessors' views on capacity and willingness to comply
- Main aspects of compliance and non-compliance
- Action plan proposed
- Supervisory agency's views on assessment issues
- Results of assessments are considered the "property" of the country being assessed - disclosure is permitted on a voluntary basis

# The Core Principles and Broader Financial Stability Issues

# Supervisors Can Not Do It Alone!

- The Core Principles highlight the need for non-supervisory elements of financial stability to be appropriately handled
- The “preconditions” cover four broad areas:
  - Sound and sustainable macro-economic policies
  - A well-developed public infrastructure
  - Effective market discipline
  - Public safety net

# Sound and Sustainable Macro-Economic Policies

- Sound macro-economic policies are the foundation of a stable financial system
- While supervisors typically have little control over such policies, it is important for them to communicate to government authorities their views/concerns regarding the potential impact of such policies on the safety and soundness of individual banks and the banking system as a whole
- Supervisors should also take action, where necessary, to mitigate any negative effects of such policies

# A Well-developed Public Infrastructure

- A country's infrastructure needs to include:
  - business laws (including corporate, bankruptcy, contract, consumer protection and private property laws) that are consistently enforced and provide a mechanism for the fair resolution of disputes
  - comprehensive accounting principles and rules that are widely accepted internationally
  - a system of independent audits for companies of significant size to ensure that users of financial statements, including banks, have accurate information

# A Well-developed Public Infrastructure

- A country's infrastructure needs to include:
  - an efficient and independent judiciary, and well-regulated accounting, auditing and legal professions
  - well defined rules governing, and adequate supervision of, other financial markets and, where appropriate, their participants
  - a secure and efficient payment and clearing system for the settlement of financial transactions

# Effective Market Discipline

- Effective market discipline largely depends on
  - the adequacy of information made available to market participants
  - appropriate financial incentives to reward well-managed institutions
  - arrangements that ensure that investors are not insulated from the consequences of their decisions

# Effective Market Discipline

- Market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives
- In these circumstances, it is important that, if guarantees are provided for such lending, they are disclosed and arrangements are made to compensate financial institutions when policy loans cease to perform

# Public Safety Net

- There must be mechanisms for providing an appropriate level of systemic protection for the public
- The level of protection is a public policy issue and must be addressed by the relevant authorities (including the central bank), particularly when it may result in a commitment of public funds
- Supervisors have a role to play in the determination of systemic protection because of their in-depth knowledge of the institutions involved

# Public Safety Net

- In many countries, the systemic protection framework includes some form of deposit insurance, which contributes to the maintenance of public confidence in the system
- Deposit insurance can also limit contagion from banks in distress
- Any forms of deposit insurance systems must be designed so as not to eliminate the benefits of market discipline

# Typical Weaknesses in Preconditions

- The IMF-World Bank assessments have highlighted some typical weaknesses in preconditions, as follows:
  - Inadequate bankruptcy laws
  - long delays in loan collection and procedures for collateral foreclosure due to overloaded courts or courts subject to undue influence
  - weak accounting standards
  - lack of reliable financial reports and delays in the publication of annual accounts

# Typical Weaknesses in Preconditions

- poor quality audits
- supervisory analytical frameworks that are not fully capable of taking into account the implications of macro-economic conditions for banking systems (often due to a lack of accurate data and/or insufficient IT resources)

# Concluding Remarks

# Frequently Asked Questions

- Are some Principles more important than others?
- Can one set of Principles be adequate for a broad range of countries at different stages of development?
- What are the most common impediments to full implementation?
  - Lack of resources, training, autonomy

# Conclusion

- High quality supervision can:
  - strengthen national banking systems
  - contribute to greater stability in the financial sector as a whole
  - reduce vulnerability of the domestic economy to external shocks
- Remember: while the cost of supervision may be high, the cost of lax supervision is even higher!