2. Risk types, Risk Management Corporate Governance, and the Basel Core Principles

Asia Pacific Economic Cooperation Forum –
Financial Regulators Training Initiative –
Bank Analysis and Supervision Seminar

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Part I: Risk Types and Risk Management

Definition of Risk?

1. Possibility of suffering harm or loss. Danger.
2. A factor, course, or element involving uncertain danger: hazard.
3. Opportunity for gain and loss.

Risk continuum

Firm-specific **Systemic**

Where on the continuum would these risks fit?

Fire	Liquidity crunch	Robbery
Fraud	Administrative errors	Loan loss
Typhoon	Counterparty failure	Accident
Currency crisis	Interest rate increase	Flood

For financial institutions…

…risk is the potential that events, expected or unanticipated, may have an adverse impact on the institution's **capital** or **earnings**.

Risk Categories

- For this class, and similar to the perspective of some banking supervisors, we will use 7 broad categories of risks in banks and financial institutions.
- Other specific types of risk fit within the 7 categories.
- These 7 banking risks focus on the potential effect to a bank's capital and earnings.

______ Risk

Definition:

_________ Risk is the inherent risk to earnings or capital arising when a borrower or counterparty fail to meet the terms of a contract or do not fully perform as agreed by provision of contracts.

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________ Risk

Definition:

________ Risk is the risk that movements in market rates, including foreign exchange rates, interest rates, credit spreads, and equity and commodity prices will reduce the bank's income or the value of its portfolios.

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_______ Risk types

- Interest rate risk …arises from movements in interest rates.
- Foreign exchange risk …arises from movements in foreign exchange rates.
- Commodity or Price risk …arises from adverse changes in the values of financial instruments and other investments or assets owned…

___________ Risk

Definition:

__________ Risk is the risk arising from the inability to meet obligations on time without incurring unacceptable losses.

_______________ Risk

Definition:

_____________ Risk is the risk of loss resulting from inadequate or failed internal processes, people, systems, or from external events. Absent its own category, Legal Risks arising from non-regulatory issues are included here.

______________ Risk

Definition:

____________ Risk is the inherent risk to earnings or capital arising from negative public opinion of the image, trademark, or products of the financial institution.

____________ Risk

Definition:

____________ Risk is the inherent risk to earnings or capital arising from strategies, improper implementation of strategies, or inability to adapt to changes in the bank's business environment.

____________Risk

Definition:

____________ Risk is the inherent risk to earnings or capital arising from nonconformance with, laws, rules, regulations, prescribed practices, internal policies and procedures, or ethical standards.

What about __________ risk?

Definition:

__________Risk is the inherent risk to earnings or capital due to the transmission of [perceived or realized] risks from one financial institution to another or from one country to another.

Some definitions of __________ risk discuss spillover effects on entire financial systems.

Risk Management

TASKS

- Identify
- Measure
- Monitor
- Control

Risk Management

PROCESSES

- Board Oversight (BO)
- Policies, procedures, processes, and limits (P3L)
- Management Information Systems (MIS)
- Internal Controls and Internal Audit (IC/IA)

Board Oversight (BO) (1/3)

Board Oversight (BO) (2/3)

Board of Directors:

- sets strategy and high-level policies for every risk function
- hires, fires, and compensates senior management
- is responsible for largest loans and insider transactions
- receives reports from internal audit
- is accountable to shareholders, supervisor, public, and courts for bank's success / failure

Board Oversight (BO) (3/3)

- Board may choose to delegate authorities to specific senior managers or to committees
- If authority delegated, Board is still responsible for overseeing individual or group

Policies, Procedures, Processes, and Limits (P3L) (1/2)

Policies, Procedures, Processes, and Limits (P3L) (2/2)

- [Board sets strategy and high-level policy]
- Management recommends operating policy and implements operating procedures
- Employees follow procedures and processes
- Board and management set limits

Management Information Systems (MIS) (1/2)

Paper *Laptops* *or Networks*

Management Information Systems (MIS) (2/2)

- Track transactions, positions, performance
- Summarize current standing
- Provide way to compare to limits
- Enable flexible views: high level to very precise

Internal Controls and Internal Audit (IC/IA) (1/5)

Internal Controls and Internal Audit (IC/IA) (2/5)

- Internal controls exist within bank procedures
- Employees and management follow IC in every significant transaction
- Some banks may have IC department to track risky transactions
- IC helps to ensure that processes followed *before a transaction is made final*

Internal Controls and Internal Audit (IC/IA) (3/5)

- Internal Audit should be a separate, independent function reporting to Board.
- IA should have appropriate independence, staff, pay, authority, access, schedule…
- IA makes regular reports of actions to Board.
- IA reviews *whether or not P3L have been followed and whether or not risks have been managed per strategy, policies, procedures.*

Internal Controls and Internal Audit (IC/IA) and other oversight tools: (4/5)

"Credit Review" is another independent function which may be considered part of IC/IA. Its function is closer to IA since it usually specializes in determining whether loans have appropriate internal grades

- Like IA, it should report separately to high level in the bank: Board or its Audit Committee
- Also like IA, Credit Review should have good staff, pay, independence, authority, access…

Internal Controls and Internal Audit (IC/IA) and other oversight tools: (5/5)

"Independent" Risk Management

- Risk Management (RM) focuses on understanding, gathering, summarizing, and reporting data on risk-taking activities. RM typically reports to senior management, so **it is not independent** like Internal Audit.
- RM is usually independent from the places where risk decisions are taken (front office) and from accounting and recordkeeping (back office). **RM is a reporting function (middle office) which may also include recommending action to manage / mitigate risks.**

Part II: Corporate Governance

Corporate Governance
Long definition

Corporate Governance involves the manner in which the business and affairs of a bank are governed by its board and senior management, including how they:

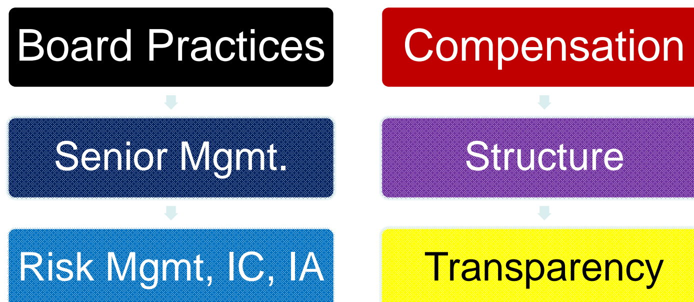
- set strategy and objectives;
- determine risk tolerance/appetite;
- operate business on a day-to-day basis;
- protect depositors, meet shareholder obligations, and consider interests of other stakeholders; and
- align corporate activities and behaviour to operate the bank in a safe and sound manner, with integrity, and in compliance with laws and regulations.

Corporate Governance
Thought

"A majority of business failures relate to what ***people*** in privileged or responsible positions actually ***do*** (or don't do) with ***other people's*** money."

Gary Simmons*, Partner*
PriceWaterhouse Coopers, Dubai

Corporate Governance
Key Aspects



Consider both **FORM** and **FUNCTION**

Corporate Governance

Board Practices

High-level Strategies, Sound Judgment, Supported by RM, IC, IA

- Qualified; Exercise sound judgment
- Overall strategy, vision, goals
- Board's own rules sound and followed
- Code of conduct
- Supported by competent and funded RM, IC processes, IA function

Corporate Governance

Senior Management

"Fit and Proper" Leadership

- Screening and approval by Board
- Disclosure of financial interests
- Implement strategy and policies within risk parameters set by Board
- Periodic performance assessment
- Succession planning

Corporate Governance

Risk Management, Internal Control, and Internal Audit

Excellent Communication and Direct Access

- Independent RM function (chief risk officer, authority, stature, independence, resources, access, ongoing review of whole and entities, broad view)
- Internal audit (charter, personnel, assessment, schedule, results, responses)
- External audit (selection, fees, engagement letter, opinion, management letter, responses)
- Internal control (mandate, functions, reports, responses)

Corporate Governance

Compensation

Compensation process ← risk outcomes

- Board oversight of compensation system
- Aligned with prudent risk taking AND actual risk outcomes

Corporate Governance

Structures: Avoid Complex or Opaque

Includes: Activities, Risk Management Framework, and recent Financial Performance

- Board: "know your structure"
  - Legal structure
  - Organizational (managerial) structure
  - Committee structure
  - Overall financial performance

Corporate Governance

Transparency and Disclosure

Board, Employees, Regulator, Public

- Structure: legal, managerial, board
- Financial performance
- Other financial indicators: nonperforming, reserves, concentrations, derivatives, etc.
- Nonfinancial indicators: code of conduct, internal control certification, internal audit summary, external audit management letter

Corporate Governance
Function

“Does bank function as it says it does?”

- Risk committees and activities
- Conflicts avoided
- Committees meet regularly
- Policies sound; Limits work
- Risk Management, Internal Audit, and Internal Control fully funded and functional
- Financial performance (vs. budget and other quality benchmarks)

Corporate Governance
BCBS

For more information:

Basel Committee on Banking Supervision

BCBS176: Principles for Enhancing Corporate Governance (October 2010)

www.bis.org/publ/bcbs176.htm

Part III:
Basel Core Principles for Effective Banking Supervision

Why Principles?

Principles provide clear guidance while neither prescribing requirements nor interfering with laws and regulations.

Why Basel?

Basel, Switzerland, is home to the Bank for International Settlements, a central banker's bank. The Basel Committee on Banking Supervision (BCBS) consists of senior representatives of bank supervisory authorities and central banks from the largest economies. The Core Principles Group included members from the BCBS and the Basel Consultative Group, which also included non-Committee member countries and regional groups of banking supervisors, as well as the IMF, the World Bank and the Islamic Financial Services Board.

BCP as Global Standard

Bank Analysis and Supervision School uses the Basel Core Principles for Effective Banking Supervision (BCP) because they:

- Apply in all economies;
- Allow for clear discussion;
- Provide sound guidance;
- Are the global standard to which bank supervisors are compared.

BCP Document Organization

Principles 1-13

Expectations of Supervisors:

- Powers
- Responsibilities
- Functions

Principles 14-29

Supervisory expectations of banks / prudential regulations:

- Good corporate governance
- Sound risk management
- Compliance with standards

The BCPs provide guidance which applies to all bank supervisors and all banks. Other detailed guidance should also be considered as appropriate including guidance on dealing with systemically important banks; macroprudential and systemic issues; crisis management, recovery, and resolution; or specific risks, systems, structures, and best practices.

41. The 29 Core Principles are:

Supervisory powers, responsibilities and functions

- ***Principle 1 – Responsibilities, objectives and powers:*** An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorise banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.
- ***Principle 2 – Independence, accountability, resourcing and legal protection for supervisors:*** The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.
- ***Principle 3 – Cooperation and collaboration:*** Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information.
- ***Principle 4 – Permissible activities:*** The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word "bank" in names is controlled.
- ***Principle 5 – Licensing criteria:*** The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home supervisor is obtained.
- ***Principle 6 – Transfer of significant ownership:*** The supervisor has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
- ***Principle 7 – Major acquisitions:*** The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
- ***Principle 8 – Supervisory approach:*** An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.
- ***Principle 9 – Supervisory techniques and tools:*** The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach

and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.

- ***Principle 10 – Supervisory reporting:*** The supervisor collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts.
- ***Principle 11 – Corrective and sanctioning powers of supervisors:*** The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking licence or to recommend its revocation.
- ***Principle 12 – Consolidated supervision:*** An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.
- ***Principle 13 – Home-host relationships:*** Home and host supervisors of cross-border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.

Prudential regulations and requirements

- ***Principle 14 – Corporate governance:*** The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organisational structure, control environment, responsibilities of the banks' Boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.
- ***Principle 15 – Risk management process:*** The supervisor determines that banks have a comprehensive risk management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (incuding robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank.
- ***Principle 16 – Capital adequacy:*** The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.
- ***Principle 17 – Credit risk:*** The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis. The full credit

lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.

- ***Principle 18 – Problem assets, provisions and reserves:*** The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.
- ***Principle 19 – Concentration risk and large exposure limits:*** The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
- ***Principle 20 – Transactions with related parties:*** In order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.
- ***Principle 21 – Country and transfer risks:*** The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk and transfer risk in their international lending and investment activities on a timely basis.
- ***Principle 22 – Market risks:*** The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.
- ***Principle 23 – Interest rate risk in the banking book:*** The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.
- ***Principle 24 – Liquidity risk:*** The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.
- ***Principle 25 – Operational risk:*** The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk on a timely basis.
- ***Principle 26 – Internal control and audit:*** The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into

account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

- ***Principle 27: Financial reporting and external audit:*** The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.
- ***Principle 28 – Disclosure and transparency:*** The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.
- ***Principle 29 – Abuse of financial services:*** The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

42. The Core Principles are neutral with regard to different approaches to supervision, so long as the overriding goals are achieved. They are not designed to cover all the needs and circumstances of every banking system. Instead, specific country circumstances should be more appropriately considered in the context of the assessments and in the dialogue between assessors and country authorities.

43. National authorities should apply the Core Principles in the supervision of all banking organisations within their jurisdictions.[12] Individual countries, in particular those with advanced markets and banks, may expand upon the Core Principles in order to achieve best supervisory practice.

44. A high degree of compliance with the Core Principles should foster overall financial system stability; however, this will not guarantee it, nor will it prevent the failure of banks. Banking supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are part of risk-taking.

45. The Committee stands ready to encourage work at the national level to implement the Core Principles in conjunction with other supervisory bodies and interested parties. The Committee invites the international financial institutions and donor agencies to use the Core Principles in assisting individual countries to strengthen their supervisory arrangements. The

[12] In countries where non-bank financial institutions provide deposit and lending services similar to those of banks, many of the Principles set out in this document would also be appropriate to such non-bank financial institutions. However, it is also acknowledged that some of these categories of institutions may be regulated differently from banks as long as they do not hold, collectively, a significant proportion of deposits in a financial system.

BASS will focus especially on these BCPs:

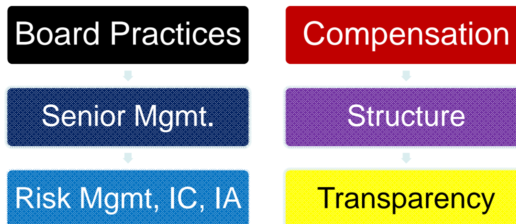
Supervisors:
8 Supervisory Approach
9 Tools and Techniques
10 Supervisory Reporting

Banks (Prudential Regs):
14 Corporate Governance
15 Risk Management
16 Capital Adequacy
17-21 Credit Risk, Problem Assets, Credit Concentrations, Related Parties, Country / Transfer Risks
22-23 Market Risk and IRR

24 Liquidity	27 Reports & EA
25 Operational	28 Disclosure &
26 IC & IA	Transparency

To begin, BCP 14 – Corporate Governance

Essential Criteria include:
- Legal framework
- Regular assessment
- Qualified, fit & proper Board
- Set and oversee strategy
- Choose and oversee proper senior management
- Board and management understand & manage risks
- Supervisor can require changes



And Board should inform supervisor of any material information reflecting negatively on Board or Sr. Mgmt.

BCP 15 – Risk Management

Essential Criteria include:

- Risk culture / appetite
- Strategies & Policies approved & communicated
- Risks understood; ICAAP
- Adequate MIS
- Models understood and reasonable; Stress tests
- Key risk standards
- New products evaluated
- Contingency plans
- All material risks covered!

BCP 26 – Internal Controls and Internal Audit

Internal control:

- Framework, policies, controls (4 eyes), and safeguards in place
- Back-office staffing and expertise appropriate
- Adequately staffed, well-trained, permanent compliance function

Internal Audit:

- Independent, permanent, effective internal audit
- Audit –
  - is well staffed and informed;
  - has authority and access to all relevant materials;
  - uses sound methodology to identify risks, prepare plan, execute it, and report

BCP 27 – Financial Reporting and External Audit

Financial reporting

- Boards and management responsible
- Audit opinion and disclosure of annual financial statements required
- Valuation and estimation processes consistent with appropriate standards

External audit

- Laws or regulations set, scope, standards, and risk-based audit approach
- Audit covers specific risk-taking activities, assets, and off-balance sheet items
- Auditor expertise must fit
- Rotation required
- Supervisor / Auditor communication & reporting

BCP 28 – Disclosure and Transparency

- Public disclosures required: consolidated and/or solo basis
- Content is quantitative, qualitative, and comprehensive
- Disclose all material entities in group structure
- Supervisor or another agency enforces standards
- Aggregate data published periodically → market discipline

(b) compile and analyse operational risk data; and

(c) facilitate appropriate reporting mechanisms at the banks' Boards, senior management and business line levels that support proactive management of operational risk.

7. The supervisor requires that banks have appropriate reporting mechanisms to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.

8. The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk management programme covers:

(a) conducting appropriate due diligence for selecting potential service providers;

(b) structuring the outsourcing arrangement;

(c) managing and monitoring the risks associated with the outsourcing arrangement;

(d) ensuring an effective control environment; and

(e) establishing viable contingency planning.

Outsourcing policies and processes require the bank to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.

Additional criterion

1. The supervisor regularly identifies any common points of exposure to operational risk or potential vulnerability (eg outsourcing of key operations by many banks to a common service provider or disruption to outsourcing providers of payment and settlement activities).

Principle 26: Internal control and audit

The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent[80] internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

(Reference documents: *The internal audit function in banks*, June 2012; *Enhancements to the Basel II framework*, July 2009; *Compliance and the compliance function in banks*, April

[80] In assessing independence, supervisors give due regard to the control systems designed to avoid conflicts of interest in the performance measurement of staff in the compliance, control and internal audit functions. For example, the remuneration of such staff should be determined independently of the business lines that they oversee.

2005; and *Framework for internal control systems in banking organisations*, September 1998.)

Essential criteria

1. Laws, regulations or the supervisor require banks to have internal control frameworks that are adequate to establish a properly controlled operating environment for the conduct of their business, taking into account their risk profile. These controls are the responsibility of the bank's Board and/or senior management and deal with organisational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments (including measures for the prevention and early detection and reporting of misuse such as fraud, embezzlement, unauthorised trading and computer intrusion). More specifically, these controls address:

    (a) organisational structure: definitions of duties and responsibilities, including clear delegation of authority (eg clear loan approval limits), decision-making policies and processes, separation of critical functions (eg business origination, payments, reconciliation, risk management, accounting, audit and compliance);

    (b) accounting policies and processes: reconciliation of accounts, control lists, information for management;

    (c) checks and balances (or "four eyes principle"): segregation of duties, cross-checking, dual control of assets, double signatures; and

    (d) safeguarding assets and investments: including physical control and computer access.

2. The supervisor determines that there is an appropriate balance in the skills and resources of the back office, control functions and operational management relative to the business origination units. The supervisor also determines that the staff of the back office and control functions have sufficient expertise and authority within the organisation (and, where appropriate, in the case of control functions, sufficient access to the bank's Board) to be an effective check and balance to the business origination units.

3. The supervisor determines that banks have an adequately staffed, permanent and independent compliance function[81] that assists senior management in managing effectively the compliance risks faced by the bank. The supervisor determines that staff within the compliance function are suitably trained, have relevant experience and have sufficient authority within the bank to perform their role effectively. The supervisor determines that the bank's Board exercises oversight of the management of the compliance function.

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[81] The term "compliance function" does not necessarily denote an organisational unit. Compliance staff may reside in operating business units or local subsidiaries and report up to operating business line management or local management, provided such staff also have a reporting line through to the head of compliance who should be independent from business lines.

4. The supervisor determines that banks have an independent, permanent and effective internal audit function[82] charged with:
   (a) assessing whether existing policies, processes and internal controls (including risk management, compliance and corporate governance processes) are effective, appropriate and remain sufficient for the bank's business; and
   (b) ensuring that policies and processes are complied with.

5. The supervisor determines that the internal audit function:
   (a) has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;
   (b) has appropriate independence with reporting lines to the bank's Board or to an audit committee of the Board, and has status within the bank to ensure that senior management reacts to and acts upon its recommendations;
   (c) is kept informed in a timely manner of any material changes made to the bank's risk management strategy, policies or processes;
   (d) has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties;
   (e) employs a methodology that identifies the material risks run by the bank;
   (f) prepares an audit plan, which is reviewed regularly, based on its own risk assessment and allocates its resources accordingly; and
   (g) has the authority to assess any outsourced functions.

Principle 27: Financial reporting and external audit

The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.

(Reference documents: *Supervisory guidance for assessing bank' financial instruments fair value practices*, April 2009; *External audit quality and banking supervision*, December 2008; and *The relationship between banking supervisors and banks' external auditors*, January 2002.)

Essential criteria

1. The supervisor[83] holds the bank's Board and management responsible for ensuring that financial statements are prepared in accordance with accounting policies and

[82] The term "internal audit function" does not necessarily denote an organisational unit. Some countries allow small banks to implement a system of independent reviews, eg conducted by external experts, of key internal controls as an alternative.

[83] In this Essential Criterion, the supervisor is not necessarily limited to the banking supervisor. The responsibility for ensuring that financial statements are prepared in accordance with accounting policies and practices may also be vested with securities and market supervisors.

practices that are widely accepted internationally and that these are supported by recordkeeping systems in order to produce adequate and reliable data.

2. The supervisor holds the bank's Board and management responsible for ensuring that the financial statements issued annually to the public bear an independent external auditor's opinion as a result of an audit conducted in accordance with internationally accepted auditing practices and standards.

3. The supervisor determines that banks use valuation practices consistent with accounting standards widely accepted internationally. The supervisor also determines that the framework, structure and processes for fair value estimation are subject to independent verification and validation, and that banks document any significant differences between the valuations used for financial reporting purposes and for regulatory purposes.

4. Laws or regulations set, or the supervisor has the power to establish the scope of external audits of banks and the standards to be followed in performing such audits. These require the use of a risk and materiality based approach in planning and performing the external audit.

5. Supervisory guidelines or local auditing standards determine that audits cover areas such as the loan portfolio, loan loss provisions, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, consolidation of and other involvement with off-balance sheet vehicles and the adequacy of internal controls over financial reporting.

6. The supervisor has the power to reject and rescind the appointment of an external auditor who is deemed to have inadequate expertise or independence, or is not subject to or does not adhere to established professional standards.

7. The supervisor determines that banks rotate their external auditors (either the firm or individuals within the firm) from time to time.

8. The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.

9. The supervisor requires the external auditor, directly or through the bank, to report to the supervisor matters of material significance, for example failure to comply with the licensing criteria or breaches of banking or other laws, significant deficiencies and control weaknesses in the bank's financial reporting process or other matters that they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations provide that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.

Additional criterion

1. The supervisor has the power to access external auditors' working papers, where necessary.

Principle 28: Disclosure and transparency

The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects

their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.

(Reference documents: *Pillar 3 disclosure requirements for remuneration*, July 2011; *Enhancements to the Basel II framework*, July 2009; *Basel II: International measurement of capital measurement and capital standards*, June 2006; and *Enhancing bank transparency*, September 1998.)

Essential criteria

1. Laws, regulations or the supervisor require periodic public disclosures [84] of information by banks on a consolidated and, where appropriate, solo basis that adequately reflect the bank's true financial condition and performance, and adhere to standards promoting comparability, relevance, reliability and timeliness of the information disclosed.

2. The supervisor determines that the required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, aggregate exposures to related parties, transactions with related parties, accounting policies, and basic business, management, governance and remuneration. The scope and content of information provided and the level of disaggregation and detail is commensurate with the risk profile and systemic importance of the bank.

3. Laws, regulations or the supervisor require banks to disclose all material entities in the group structure.

4. The supervisor or another government agency effectively reviews and enforces compliance with disclosure standards.

5. The supervisor or other relevant bodies regularly publishes information on the banking system in aggregate to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).

Additional criterion

1. The disclosure requirements imposed promote disclosure of information that will help in understanding a bank's risk exposures during a financial reporting period, for example on average exposures or turnover during the reporting period.

Principle 29: Abuse of financial services

The supervisor determines that banks have adequate policies and processes, including strict customer due diligence (CDD) rules to promote high ethical and professional standards in

[84] For the purposes of this Essential Criterion, the disclosure requirement may be found in applicable accounting, stock exchange listing, or other similar rules, instead of or in addition to directives issued by the supervisor.

Core Principles for Effective Banking Supervision
BCBS

For more information:

Basel Committee on Banking Supervision

BCBS230: Core Principles for Effective Banking Supervision (September 2012)

www.bis.org/publ/bcbs230.htm

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BASS will focus on these BCPs:

Supervisors:

8 Supervisory Approach

9 Tools and Techniques

10 Supervisory Reporting

Banks (Prudential Regs):

~~14 Corporate Governance~~ ✓

~~15 Risk Management~~ ✓

16 Capital Adequacy

17-21 Credit Risk, Problem Assets, Credit Concentrations, Related Parties, Country / Transfer Risks

22-23 Market Risk and IRR

24 Liquidity

25 Operational

~~26 IC & IA~~ ✓

~~27 Reports & EA~~ ✓

~~28 Disclosure & Transparency~~ ✓

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