The Revised Core Principles for Effective Banking Supervision

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What are the Core Principles?

- 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 Recent 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 Mexico (October 2006)
The Revision Process

- The overall number of Principles remains at 25
- The number of assessment criteria has increased from 227 to 245
- Some Principles have been merged in order to make room for new ones – specifically related to risk management, as well as interest rate, liquidity and operational risk
The Core Principles for Effective Banking Supervision – A Summary
The Core Principles cover a broad range of 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 authority
- Operational independence, **accountability, transparency, sound governance** and adequate resources
- A suitable legal framework for authorisation of banking establishments and their ongoing supervision
- A suitable legal framework for addressing compliance with laws, as well as safety and soundness
- 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, at a minimum:

- 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

- There is no requirement in the revised Principle 6 on capital adequacy that individual countries adopt either Basel I or Basel II.
- For internationally-active banks, the national requirements “must not be less than those established in the applicable Basel requirement” (either Basel I or Basel II).
- The IMF is currently in the process of developing assessment criteria for those countries that opt to implement part or all of Basel II.
Prudential Regulations and Requirements

- A major change in this section is the addition of a separate Principle (#7) 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
Prudential Regulations and Requirements

- This section now also has stand-alone Principles on:
  - Liquidity risk
  - Operational risk
  - Interest rate risk in the banking book

- This highlights the importance of these risks and the fact that there is now more attention given to them (most particularly under Basel II) by bank management and supervisors.
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
Corporate Governance and the Core Principles

- Corporate governance is not treated as a “stand-alone” concept but rather is an important part of many of the Principles
- There are numerous essential criteria related to the role of the board and senior management:
  - Licensing process
  - Risk management
  - Internal control and audit
Corporate Governance and the Core Principles

- Terminology in the Core Principles methodology:
  - “a bank’s Board approves and periodically reviews…”
  - “banks have appropriate policies and processes…”
  - “the Board and senior management receive timely and appropriate information…”
  - “… subject to prior approval by the bank’s Board”
  - “senior management monitors…”
  - “the Board provides oversight of these transactions”
  - “banks have a strategy that…”
  - “effective systems in place to identify, measure, monitor and control…”
Principle 7: Risk Management Process

- The new Principle 7 on risk management, in particular, highlights many of the most important aspects of corporate governance.
- It is meant to be an umbrella Principle for all of the ones that follow related to credit, market, liquidity, operational and interest rate risk (Principles 8-16).
- It is also closely related to many of the themes contained in Basel II, especially those related to qualitative requirements.
Principle 7: Risk Management Process

- Some noteworthy essential criteria in Principle 7:
  - The supervisor confirms that banks have appropriate risk management strategies that have been approved by the Board… and senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies.
  - The supervisor determines that risk exceptions to established policies, processes and limits receive the prompt attention of and authorisation by the appropriate level of management and the Board, where necessary.
Principle 7: Risk Management Process

- Some noteworthy essential criteria in Principle 7:
  - The supervisor determines that senior management and the Board understand the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels.
  - The supervisor determines that banks have risk evaluation, monitoring, and control or mitigation functions with duties clearly segregated from risk-taking functions, and which report on risk exposures directly to senior management and the Board.
Principle 17: Internal Control and Audit

- Principle 17 also covers critical aspects of corporate governance, including:
  - Clear arrangements for delegating authority and responsibility
  - Separation of certain critical functions
  - Internal audit and compliance functions to test adherence to controls, policies and processes
The Core Principles for Effective Banking Supervision – Implementation
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
In many countries QUALITY implementation will be a long process, as it requires:

- A competent and motivated body of professional supervisors
- A banking regulatory framework that supports sound banking practices
- A sound credit culture that includes reasonable lending practices
- Adequate accounting, reporting and disclosure requirements that support financial transparency
Steps to Achieving Implementation

- First step: fact finding - identification of areas where changes will be necessary (self-assessment process)
- In many countries, substantive changes in the legislative framework have been necessary (this can be a lengthy process as it is in the hands of the politicians!)
- Establishment of a timetable
- External pressures (especially market forces)
The Assessment Process
Initial Problems with Assessments

- Self-assessments found to be unsatisfactory
- Basel Committee lacked willingness and resources to do assessments
- Peer review was politically charged
- Private consultants could not be strictly objective
- IMF and World Bank took on the responsibility of conducting assessments but their initial assessments revealed additional problems
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 Basel II
Treatment of Basel II in the Revised Core Principles

- There is no Principle requiring a country to adopt Basel II (or Basel I)
- The Basel Committee does not consider Basel II implementation necessary for compliance with the Core Principles
- The sound banking and supervisory practices incorporated in Basel II (e.g. risk management, disclosure) are now better reflected in the Core Principles Methodology criteria
Core Principles = Solid Foundation

- Basel II requires an appropriate infrastructure
- Compliance with Core Principles is crucial
  - Appropriate risk management techniques
  - Sound accounting and provisioning standards
  - System of effective supervision
  - Adequate home-host country arrangements
- All three pillars of Basel II are reflected in most of the individual principles
Time schedule for Implementation of Basel II

- When should Basel II be implemented?
  - Only national authorities can answer this question
  - Timing should be determined by a country’s own circumstances
  - Basel II may be a lesser priority compared to other efforts

- Basel II Framework (June 2004)
  - “This document is being circulated to supervisory authorities worldwide with a view to encouraging them to consider adopting this revised Framework at such time as they believe is consistent with their broader supervisory priorities.” (Paragraph 3)
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?
● Which version of the Core Principles are being used now for FSAP reviews and will there be a transition period?
● Will the results of the external assessments ever be made public by the IMF/World Bank?
● 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!
Questions

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