Core Principles for Effective Banking Supervision

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Seminar for Senior Bank Supervisors

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Core Principles for Effective Banking Supervision

Outline

- Definition
- Process
- Structure and Content
- Implementation
- Methodology
- Survey/self-assessment
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Definition

- Set of supervisory guidelines aimed at providing a general framework for effective banking supervision
- Reference document for the use of national supervisors and international institutions
Core Principles are not

- A remedy for economic mismanagement
- A guarantee that no bank will fail
- A rigid set of standards
- A “quick fix”
- Something to be ignored
Three “firsts”

- First truly joint G-10/non-G-10 product
- First comprehensive document
- A significant political statement

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

- Need to improve the strength of the financial systems
- Issued in September 1997
- Work done by members of the Basel Committee and by Non G-10
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**Process**

- Lyon Summit 1996 - G-7 Heads of Government
- November: joint meeting of Basel Committee and representatives from 15 non-G-10 countries
- Mid-December: meeting of a small drafting group comprised of 5 G-10 and 7 non-G-10 countries
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Process (continued)

- Informal consultation process: regional groups, IMF, World Bank
- Mid-February 1997: second meeting of the drafting group
- Presented at Denver Summit (June 1997)
- Approval of final document and presentation in Hong Kong (September 1997)
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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
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Structure and Content

- Cover a broad range of supervisory topics
- General but comprehensive
- On many issues ➔ existence of a Basel Committee document
- On other issues ➔ documents containing more detailed guidance to be developed.
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Introduction (Section 1):

• “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.”
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Introduction (Section 1):

- Banking supervision $$
- Poor supervision $$$$$$
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Efficient and competitive banking system

good quality financial service

at reasonable $$
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Preconditions for Effective Banking Supervision (Section II)

Principle 1

- infrastructure elements required to support effective supervision.
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Supervisors cannot do it alone!!!

1. Sound and sustainable macro-economic policies
2. A well-developed public infrastructure
3. An effective market discipline
Preconditions for Effective Banking Supervision (continued)

4. Procedures for efficient resolution of problems

5. Appropriate level of systemic protection
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Preconditions for Effective Banking Supervision

- Clear responsibilities and objectives for each agency
- Operational independence and adequate resources
- Suitable legal framework for banking supervision
- Arrangements for information-sharing among supervisors
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Licensing Process and Approval for Changes in Structure (Section III) Principles 2 to 5
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Arrangements for Ongoing Banking Supervision (Section IV)
16 of the 25 principles

Essence of ongoing supervision

Three sections:

- Prudential regulation and requirements
  *Principles 6 through 15*

- Methods of ongoing banking supervision
  *Principles 16 through 20*

- Information requirements
  *Principle 21*
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Main prudential Regulations and Requirements:

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

Principle 21: Supervisors must be satisfied that:

– adequate records consistent accounting policies and practices
– true and fair view of the financial condition
– publication on a regular basis of financial statements
Information Requirements

- Accounting standards
- Scope and frequency of reporting
- Confirmation of the accuracy of information submitted
- Confidentiality of supervisors' information
- Disclosure
"Supervision cannot, and should not, provide an assurance that banks will not fail (the possible “expectation gap” that could generate moral hazard)."
Cross-border Banking (Section VI)

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

Reference: Basel Concordat
and *The supervision of cross-border banking*
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The challenge for supervisors is QUALITY implementation of the Core Principles

- The Core Principles are providing the necessary foundation to achieve a sound supervisory system
- Local characteristics need to be taken into account in the specific way in which these standards 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 risks and general conditions prevailing in the local market.
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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 supports sound lending practices
- Adequate accounting, reporting and disclosure requirements that support financial transparency.
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Steps to Achieving Implementation

- First step: fact finding - identification of areas where changes will be necessary
- In many countries, substantive changes in the legislative framework are necessary
- Establishment of a timetable
- Role of the IMF/IBRD
- External pressures (especially market forces)
Role of the Basel Committee in the implementation process

- Creation of the Core Principles Liaison Group
- 1998 Survey (results discussed at Sydney ICBS)
- Further detailed papers to provide support to the Core Principles
- Development of criteria for determining adequacy of implementation ("Core Principles Methodology")
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Role of the Basel Committee in the implementation process

- The Core Principles Liaison Group consists of:
  - representatives from 7 G-10 countries (France, Germany, Italy, Japan, the Netherlands, the United Kingdom, and the United States)
  - representatives from 15 non-G-10 countries (Argentina, Australia, Brazil, Chile, China, the Czech Republic, Hong Kong, Korea, India, Mexico, Russia, Saudi Arabia, Singapore, South Africa and West Africa)
  - representatives from the IMF and the World Bank
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Role of the Basel Committee in the implementation process

- Further detailed papers to provide support to the Core Principles
  - Internal controls
  - Credit risk management
  - Liquidity risk management
  - Corporate governance
  - Accounting standards
Role of the Basel Committee in the implementation process

Core Principles Methodology

- Development of criteria for determining adequacy of implementation
- Criteria divided into two categories:
  - Essential criteria
  - Additional criteria
- IMF/World Bank agreement on approach to assessments
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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?
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The methodology for assessing compliance with the Core Principles

- 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
The self assessment survey: 127 countries; a response rate of 80%. 

- Problems with self assessments
- Lack of direction on what constitutes “implementation”
- Significant changes are presently occurring in a majority of supervisory systems
- Need for adequate resources, training
The Core Principles Survey

Four common themes so far:

- Human resources
- Financial resources
- Autonomy, especially relating to licensing
- Risk management skills.
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Lessons to be drawn from the self-assessment Survey

1. Provided a mixed but valuable information on the state of supervisory systems worldwide.

2. Clear need for training in many areas of supervision: market risks, consolidated supervision, risk management, etc.
3. Most important/commonly raised issue is the lack of skilled human resources in supervision.

4. Need for improving supervisors' ability to assess bank management, particularly during the licensing process, but not exclusively.
Self-Assessment vs External Assessment

- External assessments may be more difficult and costly because:
  - Assessors do not always have in depth knowledge of the supervisory system
  - Limited knowledge of national circumstances and infrastructure
  - Possible language and/or cultural barriers
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Self Assessment vs External Assessment

*BUT*

External assessments are more likely to be:

– Objective
– Immune to political interference
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Frequently asked questions

• Will the Core Principles be amended periodically?
• Are some Principles more important than others?
• Will the results of the external assessments be made public?
• What are the most common impediments to full implementation?
What’s ahead

1. Methodology for a self-assessment
   To be considered at the next meeting of the CPLG in Basel in November.

2. Comparison of the Core Principles issued by other supervisors (IAIS, IOSCO)
   Being done by a working group of the Joint Forum
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Conclusion:
What can good quality supervision achieve?

- Strengthen (over time) national banking systems
- Contribute to greater stability in the financial sector as a whole
- Reduce vulnerability to external shocks.
Conclusion (continued)

But it cannot:

- Create a stable macro-economic environment,
- Immunise a country to external shocks,
- Guarantee that no bank will ever fail.
The Final Word

• “banking supervision is a dynamic function that needs to respond to changes in the marketplace.”