Revised Basel Core Principles for Effective Banking Supervision

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Presentation Outline

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  - Home-Host Relationships
  - Risk-Based Supervision
  - Corporate Governance and Internal Controls
- Basel Core Principles Review
  - Core Principles and Methodology
  - IMF and World Bank Annex
- Implications
- Questions
Overview
Overview

- Basel Core Principles (BCPs) developed by Basel Committee as benchmark to assess quality of banking supervision
  - Identify strengths and weaknesses; set priorities for future work
  - Part of effort to strengthen financial system
- Globally agreed minimum standards for banking supervision and regulation
  - Universally applicable
  - Supplementary measures may be adopted
- Used by:
  - Bank supervisors in conducting self-assessments or peer reviews
  - IMF and World Bank in Financial Sector Appraisal Program (FSAP)
  - Private third parties
Original core principles (CPs) published in recognition that weaknesses in banking systems at core of many financial crises
- Identify necessary preconditions
- CPs Methodology developed to facilitate greater objectivity and comparability in assessment process
  - Provides criteria – essential and additional – for determining compliance
  - IMF and World Bank assessment format included as annex
- BCP review encompassed both documents; annex updated by IMF and World Bank
- Updated BCPs endorsed by bank supervisors from 120 countries

Timeline

**October 1999:** CPs Methodology published

**September 1997:** Original CPs published

**April 2001:** Self-assessment framework published

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**October 2006:** Revised BCPs approved

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**October 2006:** Revised BCPs approved
Rationale for Review

- BCPs have made significant contributions to enhancement of supervisory practices and global financial stability
  - More than 130 countries assessed as part of FSAP
  - Many countries have also performed self-assessments
- Review ensures continued relevance given:
  - Significant changes in supervisory approaches and methods; new guidance
  - Innovations and developments in banking and broader financial markets
  - Practical experiences gained from assessments
Main Objectives

- Promote continuity
  - Keep changes to minimum to ensure comparability to 1997 CPs
- Retain focus on banking supervision
- Maintain flexibility of BCPs to withstand test of time
  - Balanced to recognize significant developments
- Reflect sound supervisory standards already in place
  - Refer to existing Basel Committee guidance
- Enhance consistency with sectoral standards
  - Legitimate differences remain
Review Process

- Highly consultative review process
  - Built on work of Core Principle Liaison Group
    - Includes representatives from Basel Committee countries, 16 non-Committee countries, IMF and World Bank
  - Solicited feedback in consultative processes with:
    - Other standard setters
      - IAIS, IOSCO, FATF and CPSS
    - Regional supervisory groups
      - 14 groups represented from around world
    - General public
      - National supervisory authorities, central banks, international trade associations, academia and other interested parties
Important Milestones in Review

- **June 2004**: Basel Committee appoints team to establish scope and mandate of review
- **January 2005**: Three drafting teams established
- **October 2005**: Basel Committee approves preliminary draft; sent to regional groups and sectoral standard setters for comments
- **April 2006**: Basel Committee approves revised draft; issued for public comment
- **October 2006**: Basel Committee approves final document; endorsed at the ICBS
Review Focus

Update includes CPs (1997) and assessment Methodology (1999)
- Kept as two separate documents
- Methodology retains structure of essential and additional criteria
  - Changes made to individual criteria
- Annexes on state-owned banks and deposit insurance removed
  - Deposit-taking state-owned banks should be supervised on same basis as private institutions
  - Standard setting on deposit insurance left to appropriate standard setters
- IMF and World Bank updated annex on structure of and methodology for assessment reports
- Basel Committee self-assessment guidelines not updated; referred to in Methodology
Treatment of Preconditions

External elements mostly outside the direct jurisdiction of supervisors

Assessment to opine on how weaknesses in preconditions may hinder effective banking supervision
Policy Considerations
Applicability

- BCPs relevant for complex and non-complex banks and banking systems
  - Challenging to accomplish in practice

- General approach:
  - Sound practices for all banks/banking systems included as essential criteria
  - Best practices relevant for more complex banks/banking systems included as additional criteria

- Assessment to take into account “size, nature and complexity of banks’ activities”
  - Particularly relevant for risk CPs
Treatment of Basel I and II

- BCPs neutral on applicable capital standards
  - Implementation of Basel I and/or Basel II only required of countries that voluntarily do so
  - Expectation that capital requirements for internationally active banks not less than applicable Basel requirement

- Sound supervisory practices addressed in capital frameworks included in capital adequacy, risk management and disclosure CPs
  - Essential criteria where relevant for all banks/banking systems
  - Additional criteria include best practices appropriate for complex banks/banking systems

- BCPs acknowledge possibility of multiple capital frameworks
  - Provide individual framework and compliance choices
Risk Management Enhancements

- Reflect advances in risk measurement and management techniques
  - New “umbrella” risk management CP sets out requirements for integrated risk management
  - Significant enhancements to criteria related to:
    - Liquidity risk
    - Operational risk
    - Interest rate risk in the banking book
  - Expansion of criteria for CP on financial fraud, money laundering and terrorist financing
Home-Host Relationships

- Greater balance and clarity regarding home and host supervisory responsibilities and information exchange
  - Aim is to ensure adequate consolidated supervision for global banking groups
  - Frequency and scope of information shared depends on materiality of cross-border operations to:
    - Bank and financial sector for home supervisor and
    - Financial sector for host supervisor
- Reliance on existing Basel Committee guidance
Risk-Based Supervision

- Recognition of growing practice of using supervisory risk assessments in determining supervisory programs and allocating resources
  - However, supervisors in many countries rely on portfolio reviews
- BCPs provide flexible approach
  - Importance of supervisory risk assessments stressed
  - No requirement for supervisory authorities to adopt risk-based supervision
- May be an area for future work
Corporate Governance and Internal Controls

- Enhanced criteria on corporate governance and internal controls
  - Consistent with developments recognized by Basel Committee
- Effort to delineate carefully the roles of board members and senior bank management
  - Address concerns about potential blurring voiced by supervisors and industry
Basel Core Principles Review
CP 1: Objectives, Independence, Powers, Transparency and Cooperation

“Umbrella” CP covering role and responsibilities of supervisors
- Remains fundamentally the same
- More explicit recognition of need for operational independence
- Greater emphasis on transparency and accountability
- New references to cross-sector and cross-border cooperation, treated in-depth in subsequent CPs
- Recognition that supervisors increasingly employ risk-based supervisory approaches
  - Does not define or require authorities to adopt such an approach
CPs 2-5: Licensing and Structure

- Focus on permissible activities, licensing criteria, transfer of significant ownership and major acquisitions
  - Remain largely the same
  - CP2 (Permissible activities):
    - Still no global definition of “bank”
    - New requirement for supervisors to publish up-to-date list of banks
    - Explicitly addresses issue of non-banking deposit-taking financial institutions, including expectation that subject to “proportionate” regulation
  - CP 3 (Licensing criteria):
    - New references to governance, risk management and potential conflicts of interest as issues for supervisory review at authorization
  - CP 4 (Transfer of significant ownership) and CP 5 (Major acquisitions):
    - Strengthens supervisors’ powers to review and regulate these areas
CP 6: Capital Adequacy

Consistent with policy decision to accommodate multiple capital adequacy frameworks
- Capital requirements for internationally active banking organizations must not be less than applicable Basel requirement
- More clearly distinguishes between requirements for internationally active banks (as essential criteria) and non-internationally active banks (as additional criteria)
- New requirements when banks use internal assessments of risk
- Incorporation of Pillar 2 requirements
CP 7: Risk Management

- New “umbrella” CP on integrated approach to risk management
- Covers risk management common across different risk types
- Specific acknowledgement of “proportionality” - processes must be commensurate with size and complexity of institution
- Supervisors must confirm that banks’ risk management policies and processes adhered to
  - Board and senior management’s responsibility for adherence underscored
- Basel II requirements included as per policy decision
  - Bank internal capital adequacy assessment process and supervisory review included as essential criterion; non-complex banks may opt for more qualitative approaches to capital planning
  - Stress testing requirements and policies and processes for assessing reputational and strategic risk included as additional criteria
- Additional criterion on requirement for larger and more complex banks to have dedicated unit responsible for risk evaluation, monitoring and control/mitigation for material risk areas
  - Subject to periodic review by internal audit
CPs 8 (Credit Risk) and 9 (Problem Assets, Provisions and Reserves)

Both CPs revised to reflect broader context of credit risk, moving away from loan-centric focus

- CP 8 covers evaluation of assets in greater detail
  - New references to counterparty credit risk

- CP 9 reformulated to focus on management of *problem* assets
  - Greater focus on provisioning and other remedial measures
CPs 10 (Large Exposure Limits) and 11 (Exposures to Related Parties)

- Overall, very minor changes
- Updated in accordance with 2000 Basel Committee guidance
  - Clarification of “connected” and “related” parties
- CP 10 now explicitly addresses management of concentrations in addition to identification
- CP 11 somewhat more rigorous as includes definition of related party in essential (rather than additional) criterion
CPs 12 (Country and Transfer Risk) and 13 (Market Risk)

Overall, very minor changes

- No substantive changes to CP 12
  - Terminology made consistent with revisions to BCPs
- CP 13 updated to reflect developments in market risk measurement and management
  - Valuation adjustments or reserving for positions difficult to value
    - Concentrated, less liquid or stale exposures
  - Verification of market data used in valuation by function independent of business line
CPs 14 (Liquidity Risk), 15 (Operational Risk and 16 (Interest Rate Risk in Banking Book)

New CPs to reflect risks previously addressed in catch-all CP

- Reflects increasing supervisory and industry focus
- Based on Basel Committee guidance
- Recognition that banks’ policies and processes relevant to risk types must be commensurate with size and complexity of bank/risk
CPs 17 (Internal Control and Audit) and 18 (Abuse of Financial Services)

- **CP 17 updated to reflect recent Basel Committee guidance**
  - New requirement for independent compliance function
  - More emphasis on independence of audit function

- **CP 18 expanded to include financing of terrorism in addition to financial fraud and money laundering**
  - Recognizes non-banking supervisory authorities may have primary responsibility
    - Banking supervisor must cooperate with such authorities
  - Incorporates new guidance on criminal activities
    - Consistency with FATF standards enhanced yet focus on supervisor’s role in confirming adequacy of bank processes
CPs 19 (Supervisory Approach) and 20 (Supervisory Techniques)

Retain key concepts of original CPs focused on-
and off-site supervision and bank management contact

- Regrouped to facilitate assessment

CP 19 provides greater emphasis on need to assess bank systemic risk

- Supervisors to take into account developments in non-bank financial institutions

CP 20 has stricter requirement for supervisors to assess and address weaknesses in supervisory techniques and evaluate quality of banks’ internal audit function
CPs 21 (Supervisory Reporting) and 22 (Accounting and Disclosure)

- Retain key concepts related to banks’ reporting requirements
  - CP 21 focuses on banks’ supervisory reporting requirements and need for independent verification of reports
    - Verification may be completed by external experts yet supervisor must ultimately be comfortable with results
    - New reference to power of supervisors to enforce compliance and impose penalties
  - CP 22 focuses on banks’ accounting reports and their public disclosure
    - Updated to reflect developments in field
      - More robust public disclosure requirements to enforce market discipline
      - More supervisory powers related to external auditors
        - Annual rotation and access to working papers, etc.

New reference to power of supervisors to enforce compliance and impose penalties
CP 23: Corrective and Remedial Powers of Supervisors

Focuses on variety of supervisory tools to bring about timely corrective actions

- Recognition that actions vary depending on gravity of situation
- Remains largely unchanged
- More emphasis on addressing issues at an early stage, when possible
CP 24: Consolidated Supervision

Combines original CPs on domestic and cross-border consolidated supervision of banking groups

- Does not address supervision of financial conglomerates
  - Viewed as going beyond scope of Basel Committee; better addressed by Joint Forum
- New wording emphasizes need for consolidated supervision to be effective in practice
- Neutral as to whether countries should have single integrated supervisory agency or standalone agencies
CP 25: Home-Host Relationships

Combines original CPs on home-host information exchange and host country supervision

- Greater clarity of home and host responsibilities to ensure adequate supervision of cross-border banking groups
  - Recognition that frequency and scope of information shared will vary depending on materiality of cross-border operations to bank or financial sector of home supervisor or financial sector of host supervisor
  - Flexibility to be maintained surrounding information-sharing decisions
- New reference for agreed communication strategy, where necessary, reflecting size and complexity of cross-border operations
- New reference for need of host supervisors to supervise shell banks, where still exist
Areas for Potential Future Work

Only clearly established supervisory developments and sound practices incorporated in review

- Some issues that may be considered going forward:
  - Risk-based supervision
  - Reputational risk
  - Prudential regulation of credit unions and microfinance companies
  - Contagion risk from corporate ownership of banks
  - Home-host relationships
IMF and World Bank Annex

Provides comprehensive guidance and format for organization and methodology of assessment of compliance with BCPs

- Drafted and updated by IMF and World Bank
- Guidelines for grading compliance have been moved to Methodology in recognition that have become de facto global standard
  - Clarification of use of “NA” rating
  - Clarification of how “preconditions” should factor into assessment
Structure of Revised Annex

Includes sections on:

- Background information
- Methodology used
  - Mention any self-assessments
  - Identify information gaps and impact on assessment
- Institutional and macroeconomic setting
- Preconditions
  - Recommendations not part of action plan but included in general recommendations
- Principle-by-principle assessment
  - No ratings in self-assessments
- Compliance table
  - Summarizes assessments
- Recommended action plan
- Authorities’ response
Implications
Impact on Assessments

Previous assessments valid
Assessments already underway may continue to be based on 1997 CPs
- Recognizes that update of BCPs not drastic; represent existing sound practice supported by guidance
- Future assessments to be based on revised BCPs
  - Recognition that implementation of new standards may take time
  - Explicit that grading based only on essential criteria
- CPs may be met in different ways
  - Assessment criteria not to be used as “checklist”
    - Criteria NOT weighted equally
- Countries with advanced banks may elect to be assessed against additional criteria
  - No ratings, only comments
- Assessment of compliance to take into account risk profile, size and complexity of banks
- Assessments should highlight deficiencies and achievements
Future Role of Basel Committee

- Maintain role as standard-setter where guidance needed
- Prepared to assist by providing training
- Invite international financial institutions and donor agencies to use revised BCPs in efforts to strengthen countries’ supervisory arrangements
- Encourage work at national level to implement revised BCPs
  - Changes in legislation, regulations and methods of supervision
- Committed to further enhancing interaction with non-G10 supervisors, building on positive experiences of review process
Questions
Structural Changes to CPs

Total number of CPs remains 25

Four new risk CPs added:
- CP 7: Risk management (aka “umbrella risk”)
- CP 14: Liquidity risk
- CP 15: Operational risk
- CP 16: Interest rate risk in the banking book

Original CP 13 on “Other risk” deleted

Multiple CPs merged:
- CP 16: On-site/Off-site supervision
- CP 17: Bank management
- CP 18: Information requirements
- CP 19: Validation of requirements
- CP 20: Consolidated supervision
- CP 23: Global consolidated sup.
- CP 24: Information sharing
- CP 25: Host country supervision

| CP 19: Supervisory approach |
| CP 20: Supervisory techniques |
| CP 21: Supervisory reporting |
| CP 24: Consolidated supervision |
| CP 25: Home-host relationships |
CP Categorization

**Original**
- Objectives, Independence, Powers, Transparency and Cooperation (CP 1)
- Licensing and Structure (CPs 2-5)
- Prudential Regulation and Requirements (CPs 6-15)
- Methods of Ongoing Banking Supervision (CPs 16-19)
- Accounting Disclosure (CP 21)
- Corrective and Remedial Powers of Supervisors (CP 22)
- Consolidated and Cross-border Banking (CPs 20, 23-25)

**Revised**
- Objectives, Independence, Powers, Transparency and Cooperation (CP 1)
- Licensing and Structure (CPs 2-5)
- Prudential Regulation and Requirements (CPs 6-18)
- Methods of Ongoing Banking Supervision (CPs 19-21)
- Accounting and Disclosure (CP 22)
- Corrective and Remedial Powers of Supervisors (CP 23)
- Consolidated and Cross-Border Banking Supervision (CPs 24-25)
Coverage of CPs

- Objectives, Ind., etc.
- Licensing & Structure
- Prudential Regulation
- Ongoing Bank Supervision
- Accounting & Disclosure
- Corrective Powers
- Consolidated & Cross Border

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- Licensing & Structure
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