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Basel 3 News, October 2014

Dear Member,

Today we will start with something interesting: Who is really implementing Basel III and to what extent?

Seventh progress report on adoption of the Basel regulatory framework October 2014

Introduction

This report sets out the adoption status of Basel II, Basel 2.5 and Basel III regulations for each Basel Committee member jurisdiction as of end-September 2014.

It updates the Committee's previous progress reports, which have been published on a semiannual basis since October 2011.

In 2012, the Basel Committee started the Regulatory Consistency Assessment Programme (RCAP) to monitor progress in introducing regulations, assess their consistency and analyse regulatory outcomes.

As part of this programme, the Committee periodically monitors the adoption status of the risk-based capital requirements (since October 2011) and the requirements for global and domestic systemically important banks, the liquidity coverage ratio (LCR) and the leverage ratio (since October 2013).

Regarding the consistency of implementation, the Committee has published its assessment reports on seven members (Australia, Brazil, Canada, China, Japan, Singapore and Switzerland) regarding their implementation of Basel III risk-based capital regulations, which are available on its website.

Consistency assessments of the European Union and the United States are currently being concluded.

The assessments of Hong Kong SAR, India, Mexico and South Africa have begun, and include consistency of implementation of both risk-based capital standards and the Basel III LCR standards.

By early 2015, the Committee will have assessed the consistency of risk-based capital standards adopted by 19 of its 27 member jurisdictions and all members who are home jurisdictions for global systemically important banks (G-SIBs).

Regarding the analysis of regulatory outcomes, the Committee has conducted additional analytical work on risk-weighted asset (RWA) variation in the banking and trading books, which is envisaged to be published during the first half of 2015.

In addition, measures to address excessive variation are under development, and the Basel Committee expects to publish its progress later this year.

The Committee is also considering a proposal for ongoing monitoring of RWA variation from 2015.

Status of adoption of Basel III standards

Scope

The Basel III framework builds on and enhances the regulatory framework set out under Basel II and Basel 2.5.

The table attached therefore reviews members' regulatory adoption of Basel II, Basel 2.5 and Basel III.

• Basel II: Basel II, which improved the measurement of credit risk and included capture of operational risk, was released in 2004 and was due to be implemented from year-end 2006.

The Framework consists of three pillars: Pillar 1 contains the minimum capital requirements; Pillar 2 sets out the supervisory review process; and Pillar 3 corresponds to market discipline.

• Basel 2.5: Basel 2.5, agreed in July 2009, enhanced the measurements of risks related to securitisation and trading book exposures. Basel 2.5 was due to be implemented no later than 31 December 2011.

• Basel III: In December 2010, the Committee released Basel III, which set higher levels for capital requirements and introduced a new global liquidity framework.

Committee members agreed to implement Basel III from 1 January 2013, subject to transitional and phase-in arrangements.

• G-SIB framework: In July 2013, the Committee published the framework on the assessment methodology for global systemic importance and the magnitude of additional loss absorbency that global systemically important banks (G-SIBs) should have.

The requirements will be introduced on 1 January 2016 and become fully effective on 1 January 2019.

To enable their timely implementation, national jurisdictions agreed to implement by 1 January 2014 the official regulations/legislations that establish the reporting and disclosure requirements.

• D-SIB framework: In October 2012, the Basel Committee issued a set of principles on the assessment methodology and the higher loss absorbency requirement for domestic systemically important banks (D-SIBs).

Given that the D-SIB framework complements the G-SIB framework, the Committee believes it would be appropriate if banks identified as D-SIBs

by their national authorities are required by those authorities to comply with the principles in line with the phase-in arrangements for the G-SIB framework, ie from January 2016.

- **Liquidity coverage ratio: In January 2013, the Basel Committee issued the revised liquidity coverage ratio (LCR).**

The LCR underpins the short-term resilience of a bank's liquidity risk profile.

The LCR will be introduced on 1 January 2015 and will be subject to a transitional arrangement before reaching full implementation on 1 January 2019.

- **Leverage ratio: In January 2014, the Basel Committee issued the Basel III leverage ratio framework and disclosure requirements following endorsement by its governing body, the Group of Central Bank Governors and Heads of Supervision (GHOS).**

Implementation of the leverage ratio requirements has begun with bank-level reporting to national supervisors of the leverage ratio and its components, and will proceed with public disclosure starting on 1 January 2015.

- **Net stable funding ratio: In January 2014, the Basel Committee issued proposed revisions to the Basel framework's net stable funding ratio (NSFR).**

In line with the timeline specified in the 2010 publication of the liquidity risk framework, it remains the Committee's intention that the NSFR, including any revisions, will become a minimum standard by 1 January 2018.

Methodology

The information contained in the following table is based on responses from Basel Committee member jurisdictions, and reports the status as of end-September 2014.

The following classification is used for the adoption status of Basel regulatory rules:

1. Draft regulation not published: no draft law, regulation or other official document has been made public to detail the planned content of the domestic regulatory rules.

This status includes cases where a jurisdiction has communicated high-level information about its implementation plans but not detailed rules.

2. Draft regulation published: a draft law, regulation or other official document is already publicly available, for example, for public consultation or legislative deliberations. The content of the document has to be specific enough to be implemented when adopted.

3. Final rule published: the domestic legal or regulatory framework has been finalised and approved but is still not applicable to banks.

4. Final rule in force: the domestic legal and regulatory framework is already applied to banks.

In order to support and supplement the status reported, summary information about the next steps and the adoption plans being considered are also provided for each jurisdiction.

In addition to the status classification, a colour code is used to indicate the adoption status of each jurisdiction.

The colour code is used for those Basel components for which the agreed adoption deadline has passed.

Overview table

Number code: 1 = draft regulation not published; 2 = draft regulation published; 3 = final rule published; 4 = final rule in force.
Green = adoption completed; yellow = adoption in process; red = no adoption.

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
Argentina	4	4, 1	4	4, 1	4, 1	4, 3
	Final Pillar 3 rules came into force on 31 December 2013. Final rules for Pillar 1 credit risk and Pillar 2 came into force on 1 January 2013.	(4) Enhancements to the Basel II framework (July 2009): rules relating to enhancements to securitisation came into force on 1 January 2013. (1) Revisions to the Basel II market risk framework (July 2009): market risk amendments to reflect Basel 2.5 are considered a lower priority given the limited activity in Argentina.	Final Pillar 3 rules came into force on 31 December 2013. Final rules for Pillars 1 and 2 came into force on 1 January 2013.	(4) Methodology for assessing banks' domestic importance already published.[9] (1) The higher loss absorbency requirement is expected to be published soon.	(4) Final rule for the supervisory reporting requirement published on 8 November 2013, in effect from 31 March 2014.[10] (1) Haircuts, caps on inflows and run-off rates within the ranges established in Basel III are expected to be published before 1 January 2015.	(4) Banks will have to comply with the supervisory reporting regime as of the quarter ending 30 September 2014. (3) The information to the public (disclosure requirements) will have to be provided as of the first quarter of 2015.[11]
Australia	4	4	4	3, 2	4	2
				(3) APRA released its D-SIB framework in December 2013, which requires the four identified D-SIBs to hold an additional 1% in CET1 to meet the higher loss absorbency capital requirements, effective from 1 January 2016. (2) No Australian bank is on the current list of G-SIBs, although the four Australian D-SIBs fall under the public G-SIB disclosure framework. Consultation on the draft prudential standard for public G-SIB disclosures commenced in Q3 2014.	Final prudential standards were issued in December 2013 and came into effect from 1 January 2014. The suite of final reporting standards and forms and instructions was published in April 2014 and came into effect for reporting periods on or after 30 June 2014. Consultation on LCR public disclosure requirements commenced in Q3 2014.	Consultation on the draft prudential standard for the leverage ratio disclosure requirements commenced in Q3 2014.
Brazil	4	4	4	1	2	2
				G-SIB disclosure requirements and D-SIB higher loss absorbency requirements are expected to be issued in the second half of 2014.	Draft regulation issued for public consultation. Final regulation expected to be issued by end-2014.	Draft regulation issued for public consultation. Final regulation expected to be issued by end-2014.

[9] See www.bcra.gov.ar/pdfs/marco/D_SIBs.pdf and www.bcra.gov.ar/pdfs/marco/D_SIBs_i.pdf.

[10] See www.bcra.gov.ar/pdfs/comytexord/A5494.pdf and www.bcra.gov.ar/pdfs/comytexord/A5513.pdf.

[11] See www.bcra.gov.ar/pdfs/comytexord/A5606.pdf and www.bcra.gov.ar/pdfs/comytexord/A5610.pdf

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
Canada	4	4	4	3, 4	3	2
			Requiring banks to meet an "all-in" basis – thereby meeting 2019 capital levels but phasing out non-qualifying capital instruments.[12]	(3) Capital rules take effect in January 2016. (4) Final rules issued and additional supervisory expectations and disclosure obligations in effect.	Final guidance issued in May 2014.	OSFI to retain current asset-to-capital multiple until implementation of the leverage ratio in 2015. Draft guidance released in July 2014. Final guidance on the disclosure requirements to be released in September. Final guidance on the minimum requirements to be released in October.
China	4	4	4	4, 1	4	4, 1
				(4) D-SIB surcharge of 1% has been applied to the five largest Chinese banks since 2010. (1) The CBRC is reviewing the specific D-SIB supervisory framework.	The Rule on Liquidity Risk Management of Commercial Banks incorporates the domestic LCR requirement, which is consistent with the 2013 Basel III LCR standard and adopts the same phase-in	(4) A domestic leverage ratio requirement of 4% under Basel III framework has been in effect since 2012. (1) The CBRC will update the leverage ratio requirement in 2014 to adopt the revisions approved by the January

[12] Final rules for the credit valuation adjustment (CVA) issued on 10 December 2012 will come into force on 1 January 2014.

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
					period as well. The Rule (in Chinese) was published on the CBRC's website on 19 February 2014. The Rule, together with the LCR requirement, has been in effect since 1 March 2014.	GHOS meeting.
Hong Kong SAR	4	4	4, 2	2, 1	2	1
			(4) Final rules on minimum capital standards and associated disclosure requirements took effect on 1 January 2013 and 30 June 2013, respectively. (2) Proposed rules on capital buffers issued in August 2014.	(2) Proposed rules on G-SIB / D-SIB requirements issued in August 2014 (in conjunction with rules on capital buffers). (1) Industry consultation on the proposed D-SIB framework in Hong Kong closed in May 2014.	Proposed rules on LCR issued in August 2014 for consultation.	Rules on disclosure of leverage ratio expected to be issued in 2014.
India	4	4	4	3, 4	3	2
				(3) Final framework for dealing with D-SIBs published in July 2014. (4) There are no Indian banks on the list of G-SIBs. One Indian bank included in the sample of global banks for identification of G-SIBs has been issued	Final guidelines issued in June 2014	Guidelines issued in May 2012. Leverage ratio is monitored quarterly with effect from June 2013 at a minimum of 4.5% on the basis of rules published in Basel III text on 16 December 2010. Revised guidelines incorporating

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
				instructions to make disclosures starting from the financial year ended 31March 2014.		amendments to leverage ratio framework and disclosure requirements proposed by the Basel Committee in January 2014 will be issued before December 2014.
Indonesia	4	2	4	3, 1	2	2
		Basel 2.5 consultative paper was issued in 2013 to seek the industry's comments despite the fact that securitisation exposures are insignificant and prospects remain highly subdued for any material issuance. Furthermore, currently no bank adopts internal models approach for market risks. In 2014, another consultative paper will be issued to assess the urgency and level of materiality to determine whether or not the authority will need to revise the existing regulation. It is important to note that since the securitisation regulation was issued a few years ago, only one bank has acted as securitisation originator, by issuing mortgage-backed securities. Moreover, securitisation exposures held by banks as investors also remain very small, ie around 0.07% of total assets of the banking industry.	Regulation on Basel III capital was issued in 2013 and has been effectively implemented starting January 2014.	(3) Application of a capital surcharge to D-SIBs has been stipulated in Basel III capital framework issued in 2013 and is planned to be imposed starting January 2016. (1) A draft methodology of the D-SIB framework was developed in 2013. The final draft of the methodology was not published, but the methodology has been shared with relevant authorities. The Indonesian authorities will coordinate to discuss further follow up on D-SIB framework. A separate regulation will be issued to govern details of the D-SIB framework such as an overview of a methodology to designate D-SIBs, details of the application of the capital surcharge etc, with the objective of further clarifying the implementation of D-SIBs surcharge requirements as stipulated in the Basel III capital regulation issued in 2013.	A consultative paper on LCR regulation was issued in September 2014. The authority will simultaneously require some banks to assess their LCR by using data as of 31 December 2014 and report the results to the supervisors to enable them to monitor the impact of LCR implementation in Indonesia. Banks will also be required to publish their LCR on their respective websites. LCR calculation will start by using the December 2014 data and be reported to supervisors in early 2015, in line with the BCBS timeline.	Proposed regulation on leverage ratio discussed in Basel III consultative paper was released in June 2012. The proposed leverage ratio regulation in this consultative paper will be revised later in 2014 to align the proposed regulation with the 2014 leverage ratio framework. To monitor the impact of the implementation of leverage ratio in Indonesia the authority will simultaneously require (sample) banks to calculate and disclose their leverage ratio starting on the first reporting period in 2015.
Japan	4	4	4, 1	4, 1, 1	2	1
			(4) Final Basel III rule published in March 2012, and implemented in March 2013. (1) Rules covering capital conservation buffer and the countercyclical buffer not yet issued. Draft regulations expected in 2014/15.	(4) Rules requiring public disclosure of 12 indicators for assessing G-SIBs have been finalised and implemented. (1) Rules covering higher loss absorbency requirement for G-SIBs not yet issued. Draft regulations expected in 2014/15. (1) Methodology for identifying D-SIBs and rules covering higher loss absorbency requirement for D-SIBs not yet finalised and	Draft rules for LCR were published for public consultation at the end of July. The rules will be finalised in October.	Draft leverage ratio rules and monitoring frameworks will be published for public consultation in 2014. The rules will be implemented in March 2015.

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
				issued. Draft regulations expected in 2014/15.		
Korea	4	4	4	4, 1	2	1
			Final rules on minimum capital standards and associated disclosure requirements took effect on 1 December 2013 and 31 December 2013, respectively.	(4) Rules requiring public disclosure of 12 indicators for assessing G-SIBs have been finalised and implemented in December 2013. (1) D-SIB framework is currently being developed and is not yet finalised.	Draft guideline has been issued and rules on local implementation of LCR will be finalised in Q4 of 2014.	Leverage ratio disclosure requirements according to the Basel rules in January 2014 will be prepared by end-2014 and implemented from 2015.
Mexico	4	4, 1	4, 1	1	1	1
		(1) Of the outstanding regulations, Pillar 2 provisions have been partially implemented. The remaining outstanding regulations will be implemented in 2014.	(1) Rules on banks' exposure to central counterparties (CCPs) and CVA are intended to be implemented during 2014.		Financial authorities will finalise draft regulation during H2 2014. Final rule is intended to be mandatory starting on 1 January 2015 according to Basel schedule.	
Russia	4, 2, 2	4, 2	4, 3, 1	4	2	2
	(4) Simplified standardised approach for credit risk, simplified approach for market risk and the basic indicator approach for operational risk implemented. Regulations on Pillar 3 disclosure are in force starting from January 2014. (2) Draft regulation implementing IRB approach for Pillar 1 credit risk capital requirements published in February 2014. Final rule is planned to be published in the second half of 2014. (2) ICAAP recommendations are implemented. Draft regulations for Pillar 2 were published for public consultation in August 2014. They are planned to be adopted in the second half of 2014.	(4) Regulations on Pillar 3 disclosure are in force starting from 2014. Final regulation on the revised standardised approach for market risk (except for securitisation exposures and credit derivatives) in force since 1 February 2013. (2) ICAAP recommendations are implemented. Draft regulations for Pillar 2 were published for public consultation in August 2014 and are planned to be adopted in the second half of 2014.	(4) Regulation on capital definition and capital adequacy ratios (except for the securitisation framework) implemented since 1 January 2014. (3) Rules for CVA capital charge (under the standardised approach) published in November 2013. Starting from February 2014, Russian banks provide data on CVA to the Bank of Russia for monitoring purposes. CVA capital charge will come into force as a prudential requirement starting from October 2014. (1) Rules on capital buffers are being developed.	Regulation on methodology for identifying D-SIBs is in force since February 2014. Special regulation approaches are being developed.	Reporting requirement on LCR for largest banks in force since July 2014. Final rule on LCR as a prudential ratio to be published in Q4 2014.	Draft regulation on leverage ratio published in July 2013 with the parallel run period commenced in Q3 2013.
Saudi Arabia	4	4	4	2 (DSIBs)	4	3
				D-SIB framework has been finalised and the relevant regulations will be issued for implementation by January 2016.	SAMA introduced the LCR from January 2012 through circular #BCS 7390 dated 8 February 2012, and the Amended LCR from June 2013 through SAMA circular #341000107020 dated	SAMA issued its consultative draft document concerning leverage ratio framework and disclosure requirements on 17 April 2014. This document is expected to be finalised for implementation by mid-September 2015,

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
					10 July 2013.	and ready for implementation by January 2015, in line with BCBS time frame.
Singapore	4	4	4	4, 2	2	4, 2
				(4) The public disclosure and submission requirements for assessing G-SIBs are implemented with effect from 1 January 2014 in MAS Notice 637. (2) MAS has published a consultation paper on the proposed framework to identify D-SIBs in Singapore and address the risks they pose. The D-SIB requirements will be implemented by 1 January 2016, in line with BCBS's phase-in timeline.	Draft Notice for implementation of Basel III LCR in Singapore published on 6 August 2014. Final rules expected to be published in Q4 2014.	(4) MAS has published and implemented requirements on the calculation of the leverage ratio and reporting to MAS in MAS Notice 637, based on the rules published in the Basel III text dated 16 December 2010 (revised 1 June 2011). (2) MAS has published a consultation paper on proposed amendments to MAS Notice 637 to implement the leverage ratio disclosure requirements published by BCBS in January 2014. MAS will implement the disclosure requirement from 1 January 2015, in line with BCBS timeline.
South Africa	4	4	4	3	3, 1	3, 1
	The regulations that contain the Basel II, Basel 2.5 and Basel III requirements are		The capital charge for credit valuation adjustment (CVA) risk on all ZAR-	G-SIB / D-SIB requirements are addressed in regulations effected on	(3) LCR requirements are addressed in regulations effected on 1 January 2013, and	(3) A 4% leverage ratio was defined in regulations effected on 1 January 2013. The ratio is
	available on the website of the South African Reserve Bank.[13]		denominated OTC derivatives and non-ZAR OTC derivatives between domestic entities is zero-rated until 31 December 2014.[14]	1 January 2013 and a subsequent directive specifies the application of the amended capital framework, including the G-SIB / D-SIB[15] requirements. BCBS timelines are adhered to.	are being monitored. (1) Subsequent BCBS updates are being published in a directive.[16] BCBS timelines are adhered to.	currently being monitored. (1) Subsequent BCBS updates are being published in a directive. BCBS timelines are adhered to.
Switzerland	4	4	4	4	4, 3	2
				Final rule in force for G-SIBs and D-SIBs.	(4) Requirements for monitoring period for LCR published in Q1 2013. Qualitative requirements for liquidity risk management published in Q1 2013. (3) Ordinance and	All banks report the Basel III leverage ratio the first time for Q3 2014. Disclosure will start in 2015. As of 2015, subject to a one-year transition period, the Swiss G-SIB leverage ratio

13 See www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=5442.

14 This came about as a result of the extended absence of a domestic central counterparty for domestic OTC derivatives transactions.

15 The directive is available at www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=5686.

16 The directive is available at www.resbank.co.za/publications/detail-item-view/pages/publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=5626.

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
					circular on LCR rules published in July 2014. Regulation in effect as from January 2015.	requirements have to be fulfilled based on the Basel III definition of total exposure.
Turkey	4	4	4	1	4, 3	4, 3
			Final regulations issued in September 2013 and came into force on 1 January 2014.		(4) Final regulation issued. Reporting requirement is effective as of April 2014. (3) Regulatory limit will start from January 2015.	(4) Final regulation issued. Reporting requirement is effective as of January 2014. (3) Regulatory limit will start from January 2015.
United States	4	4	4	1	3	4
	US agencies announced on 21 February 2014 that eight of the largest bank holding companies and 12 subsidiary banks had been approved to exit parallel run. Those US institutions still in parallel run remain subject to Basel I capital requirements for risk-weighted assets.	Final market risk capital requirements, which incorporate Basel 2.5, became effective on 1 January 2013. Other Basel 2.5 revisions included as part of the final Basel III rule approved in July 2013 became effective 1 January 2014.	Final Basel III rule approved in July 2013, effective 1 January 2014.	US agencies currently anticipate issuance of a notice of proposed rulemaking and final rule to implement the G-SIB framework by year-end 2014.	US agencies issued a final LCR rule in September 2014. The rule comes into effect 1 January 2015.	Leverage ratio included in final Basel III rule approved in July 2013 and effective 1 January 2014. Existing US leverage ratio remains in effect. Basel III leverage ratio reporting begins 1 January 2015, and compliance with minimum requirements begins 1 January 2018. In April 2014, the US agencies finalised enhanced supplementary leverage ratio requirements for G-SIBs that are higher than minimum Basel requirements. In September 2014, the US agencies issued a final rule to incorporate the January 2014 Basel Committee revisions to the leverage ratio framework for internationally active banks.
European Union	4	4	4	3, 2	4, 1	4, 1
			Final Basel III rule approved in July 2013, effective 1 January 2014. Where necessary, detailed technical standards will be prepared by the EBA and adopted by the Commission on a timely basis. The CRD requires national authorities to issue regulations implementing a capital conservation buffer and a countercyclical buffer. For national implementation status of these capital buffers, see respective EU jurisdictions below.	(3) Mandatory G-SIB and optional D-SIB buffers implemented by Article 131 of Directive 2013/36/EU with date of application of 1 January 2016. (2) Technical standards detailing the G-SIB methodology are being consulted. For national implementation status of G-SIB and D-SIB requirements, see respective EU jurisdictions.	(4) Final liquidity reporting requirement issued. (1) Delegated act for the implementation of the LCR to be adopted by the Commission in early October 2014 for application in 2015 (cf Article 460 Regulation (EU) No 575/2013).	(4) Calculation and reporting requirements applicable since 1 January 2014. Mandatory disclosure of leverage ratio applicable from 1 January 2015 (cf Articles 451 and 521 of Regulation (EU) No 575/2013). (1) Delegated act for the implementation of the leverage ratio as modified by the Basel Committee in January 2014 to be adopted by the Commission in early October 2014 for application in 2015.
Belgium	4	4	(EU: 4) (Nat: 4)	(EU: 3, 2) (Nat: 3)	(EU: 4, 1)	(EU: 4, 1)

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
			(Follows EU process) National adoption status of capital conservation buffer and countercyclical capital buffer (CRD IV): In the context of the Basel III / CRD IV implementation, Belgian legislators have taken the opportunity to initiate a complete overhaul of the Belgian Banking Law. This law implements the full spectrum of Basel III/CRD IV buffers.	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV): In the context of the Basel III / CRD IV implementation, Belgian legislators have taken the opportunity to initiate a complete overhaul of the Belgian Banking Law. This law implements the full spectrum of Basel III/CRD IV buffers.	(Follows EU process)	(Follows EU process)
France	4	4	(EU: 4) (Nat: 4)	(EU: 3, 2) (Nat: 3)	(EU: 4, 1)	(EU: 4, 1)
			(Follows EU process) National adoption status of capital conservation buffer and countercyclical capital buffer (CRD IV): Implemented by the text (Ordinance of 20 February 2014) published in the Official	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV): Implemented by the text (Ordinance of 20 February 2014) published in the Official Journal on 21 February 2014.[18]	(Follows EU process)	(Follows EU process)

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
			Journal on 21 February 2014.[17]			
Germany	4	4	(EU: 4) (Nat: 4)	(EU: 3, 2) (Nat: 3)	(EU: 4, 1)	(EU: 4, 1)
			(Follows EU process) National adoption status of capital conservation buffer and countercyclical capital buffer (CRD IV): Rules on capital conservation buffer and countercyclical capital buffer have been transposed into national law. The requirements entered into force on 1 January 2014 and will be phased in from 1 January 2016.	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV): Rules on G-SIB / D-SIB as set out in CRD IV have been transposed into national law. The requirements entered into force on 1 January 2014 and will apply from 1 January 2016.	(Follows EU process)	(Follows EU process)
Italy	4	4	(EU: 4) (Nat: 4)	(EU: 3, 2) (Nat: 3)	(EU: 4, 1)	(EU: 4, 1)
			(Follows EU process) National adoption status of capital conservation buffer	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV):	(Follows EU process)	(Follows EU process)

[18] See www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000028625279.

[17] See www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000028625279.

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
			and countercyclical capital buffer (CRD IV): adopted.	adopted.		
Luxembourg	4	4	(EU: 4) (Nat: 2)	(EU: 3, 2) (Nat: 2)	(EU: 4, 1)	(EU: 4, 1)
			(Follows EU process) National adoption status of capital conservation buffer and countercyclical capital buffer (CRD IV): Capital conservation buffer adopted. (CSSF regulation 14-01). Draft law dealing with countercyclical capital buffer approved by the government and submitted to the parliament for approval.	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV): Draft law approved by the government and submitted to the parliament for approval.	(Follows EU process)	(Follows EU process)
Netherlands	4	4	(EU: 4) (Nat: 4)	(EU: 3, 2) (Nat: 3)	(EU: 4, 1)	(EU: 4, 1)
			(Follows EU process) National adoption status of capital conservation buffer and countercyclical capital buffer (CRD IV): These buffers were implemented in Dutch law on 1 August 2014.	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV): The G/D-SIB framework has been implemented in Dutch law as of 1 January 2014. D-SIBs have been designated as such, but the buffers will only be phased in as of 2016.	(Follows EU process)	(Follows EU process)

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
Spain	4	4	(EU: 4) (Nat: 4)	(EU: 3, 2) (Nat: 3)	(EU: 4, 1)	(EU: 4, 1)
			(Follows EU process) National adoption status of capital conservation buffer and countercyclical capital buffer (CRD IV): Law 10/2014 on supervision and solvency of credit institutions.	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV): Transposed into national law (Law 10/2014 on supervision and solvency of credit institutions).	(Follows EU process)	(Follows EU process)
Sweden	4	4	(EU: 4) (Nat: 4)	(EU: 3,2) (Nat: 4, 3, 2)	(EU: 4, 1) (Nat: 4)	(EU: 4, 1)
			(Follows EU process) National adoption status of capital conservation buffer and countercyclical capital buffer (CRD IV): National legislation is in force. The capital conservation buffer is applied in full (no phase-in). The	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV): (4) National legislation is in force, in which the supervisory authority (Finansinspektionen) has been given all required mandates. The European G-SII and	(Will follow EU process) The Basel Committee's LCR framework has been adopted in national regulations and is in force.[19]	(Follows EU process)

[19] The rule is available at http://fi.se/Folder-EN/Startpage/Regulations/Regulatory-Code/FFFS-201206/.

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
			supervisory authority has been given the legal powers to set the countercyclical buffer rate. The authority has decided to set the rate at 1% for Swedish exposures.	O-SII requirements may be set as of 2016 according to EU law. (2) The level and which firms it applies to will be decided by the supervisory authority following upcoming technical standards and guidelines from the EBA. (3) Also, the supervisory authority has been given the legal powers to set a systemic risk buffer. It has decided that a systemic risk buffer of 3% CET1 shall be applied to Sweden's four largest banking groups at group level from 1 January 2015. (Additionally, another 2% CET1 requirement has been put on these banking groups in Pillar 2.)		
United Kingdom	4	4	(EU: 4) (Nat: 2)	(EU: 3, 2) (Nat: 2)	(EU: 4, 1)	(EU: 4, 1)
			(Follows EU process) National adoption status of capital conservation buffer	(Follows EU process) National adoption status of G-SIB / D-SIB requirements (CRD IV):	(Follows EU process)	(Follows EU process)

Country	Basel II	Basel 2.5	Basel III			
			Risk-based capital	G-SIB / D-SIB requirements	Liquidity (LCR)	Leverage ratio (disclosure requirements)
			and countercyclical capital buffer (CRD IV): (2) Draft rules published in the summer (see PRA CP 5/13). As elements of the capital buffer framework require HM Treasury to designate the authority responsible for setting certain buffers and buffer rates in the United Kingdom, the PRA will make its final rules on buffers, in line with the CP proposals, once HM Treasury has made this designation. This is expected to take place shortly.	As for the capital conservation and the countercyclical buffers, HM Treasury must designate the authority responsible for setting the buffers for G-SIIs and O-SIIs. The identification and disclosure requirements for G-SIBs will be directly applicable following the completion of the EBA regulatory and implementing technical standards, respectively. The UK D-SIB (O-SII) framework will be developed following completion of the EBA guidelines on identification of O-SIIs. Where applicable to a firm, G-SII and O-SII buffers will be set by the PRA using its powers under s55M of FSMA to increase the size of the firm's combined buffer (see p6 of Appendix 2 of PRA CP5/13).		

Final rule - Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio

Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation.

Summary

In May 2014, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) issued a notice of proposed rulemaking (NPR or proposed rule) to revise the definition of the denominator of the supplementary leverage ratio (total leverage exposure) that the agencies adopted in July 2013 as part of comprehensive revisions to the agencies' regulatory capital rules (2013 revised capital rule).

The agencies are adopting the proposed rule as final (final rule) with certain revisions and clarifications based on comments received on the proposed rule.

The final rule revises total leverage exposure as defined in the 2013 revised capital rule to include the effective notional principal amount of credit derivatives and other similar instruments through which a banking organization provides credit protection (sold credit protection); modifies the calculation of total leverage exposure for derivative and repo-style transactions; and revises the credit conversion factors applied to certain off-balance sheet exposures.

The final rule also changes the frequency with which certain components of the supplementary leverage ratio are calculated and establishes the public disclosure requirements of certain items associated with the supplementary leverage ratio.

The final rule applies to all banks, savings associations, bank holding companies, and savings and loan holding companies (banking organizations) that are subject to the agencies' advanced approaches risk-based capital rules, as defined in the 2013 revised capital rule (advanced approaches banking organizations), including advanced approaches banking organizations that are subject to the enhanced supplementary leverage ratio standards that the agencies finalized in May 2014 (eSLR standards).

Consistent with the 2013 revised capital rule, advanced approaches banking organizations will be required to disclose their supplementary leverage ratios beginning January 1, 2015, and will be required to comply with a minimum supplementary leverage ratio capital requirement of 3 percent and, as applicable, the eSLR standards beginning January 1, 2018.

DATES: The final rule is effective January 1, 2015.

SUPPLEMENTARY INFORMATION:

I. Background

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) adopted the supplementary leverage ratio in July 2013 as part of comprehensive revisions to the agencies' regulatory capital rule (2013 revised capital rule).

Under the 2013 revised capital rule, a minimum supplementary leverage ratio requirement of 3 percent applies to all banking organizations that are subject to the agencies' advanced approaches risk- based capital rule (advanced approaches banking organizations).

The supplementary leverage ratio in the 2013 revised capital rule is generally consistent with the international leverage ratio introduced by the Basel Committee on Banking Supervision (BCBS) in 2010 (Basel III leverage ratio).

Under the enhanced supplementary leverage ratio standards (eSLR standards) finalized by the agencies in May 2014, U.S. top-tier bank holding companies (BHCs) with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody must maintain a leverage buffer greater than 2 percentage points above the minimum supplementary leverage ratio requirement of 3 percent, for a total of more than 5 percent, to avoid restrictions on capital distributions and discretionary bonus payments.

Insured depository institution (IDI) subsidiaries of such BHCs must maintain at least a 6 percent supplementary leverage ratio to be considered "well-capitalized" under the agencies' prompt corrective action framework.

On May 1, 2014, the agencies published in the Federal Register, for public comment, a notice of proposed rulemaking (NPR or proposed rule) to revise the definition of the denominator of the supplementary leverage ratio (total leverage exposure).

The proposed rule would have revised the supplementary leverage ratio, consistent with the January 2014 BCBS revisions to the Basel III leverage ratio (BCBS 2014 revisions), to incorporate in total leverage exposure the effective notional principal amount of credit derivatives or similar instruments through which a banking organization provides credit protection (sold credit protection), modify the measure of exposure for derivative and repo-style transactions, and revise the credit conversion factors (CCFs) for certain off-balance sheet exposures.

It would have required total leverage exposure to be calculated as the mean of total leverage exposure, calculated daily, and would have required public disclosure of certain items associated with the supplementary leverage ratio.

In general, the proposed changes were designed to strengthen the supplementary leverage ratio by more appropriately capturing the exposure of a banking organization's on- and off- balance sheet items.

As discussed further below, the agencies are adopting the proposed rule as final (final rule) with certain revisions and clarifications based on comments received on the proposed rule.

In addition, the agencies are revising the calculation of total leverage exposure to provide that the on-balance sheet portion of total leverage exposure will be calculated as the average of each day of the reporting quarter, but the off- balance sheet portion of total leverage exposure will be calculated as the average of the three month-end amounts of the most recent three months.

Consistent with the 2013 revised capital rule, advanced approaches banking organizations will be required to disclose their supplementary leverage ratios beginning January 1, 2015, and will be required to comply with the minimum supplementary leverage ratio capital requirement and, as applicable, the eSLR standards, beginning January 1, 2018.

II. Summary of Comments on the NPR and Description of the Final Rule

The agencies sought comment on all aspects of the NPR and received 14 public comments from banking organizations, trade associations representing the banking or financial services industry, an options and futures exchange, a supervisory authority, a public interest advocacy group, three private individuals, and other interested parties.

In general, comments from financial services firms, banking organizations, banking trade associations and other industry groups were supportive of the proposed rule because it would enhance international consistency, but were critical of certain aspects of the NPR.

Comments from an organization representing smaller banking organizations, a group of state bank supervisors, a public interest advocacy group, and two individuals were more generally supportive of the NPR, but they also expressed certain concerns.

One individual commenter strongly opposed the proposed rule.

A detailed discussion of the proposed rule, commenters' concerns, and the agencies' responses to those concerns are provided in the remainder of this preamble.

A. Calibration of the Supplementary Leverage Ratio and the eSLR Standards

As noted above in Part I, a U.S. top- tier BHC with more than $700 billion in consolidated total assets or more than $10 trillion in assets under custody must maintain a leverage buffer greater than 2 percentage points above the minimum supplementary leverage ratio requirement of 3 percent, for a total of more than 5 percent, to avoid restrictions on capital distributions and discretionary bonus payments.

IDI subsidiaries of such BHCs must maintain at least a 6 percent supplementary leverage ratio to be considered "well capitalized" under the agencies' prompt corrective action framework.

The NPR did not propose changes to the minimum supplementary leverage ratio or eSLR standards, but did propose changes to the denominator of the supplementary leverage ratio, which could require banking organizations subject to the supplementary leverage ratio standards (including the eSLR standards) to hold higher amounts of tier 1 capital to meet the standards.

The agencies asked in the proposal whether the proposed changes to the definition of total leverage exposure warranted any changes to the calibration of the minimum ratios, or the well-capitalized or buffer levels of the supplementary leverage ratio.

Some commenters encouraged the agencies to reconsider the eSLR standards in general, raising issues similar to the comments that the agencies received on the proposal to implement the eSLR standards.

For example, commenters expressed the view that the eSLR standards were not consistent with the BCBS's leverage ratio framework and could therefore result in competitive disparities across jurisdictions.

One commenter expressed disappointment with the decision to bifurcate the eSLR standards for BHCs and IDIs.

A number of commenters expressed concern that the NPR, in combination with the eSLR standards, could cause the supplementary leverage ratio to become the binding regulatory capital constraint, rather than a backstop to the risk-based capital measure.

These commenters concluded that a consequence of a binding supplementary leverage ratio could be that banking organizations may divest lower risk assets and assume more risk, to the detriment of financial stability.

The agencies considered these comments in connection with adopting the eSLR standards, and the agencies' views on those comments are set forth in the preamble to the final rule implementing the eSLR standards.

As noted in that preamble, and discussed further below, the agencies believe that the maintenance of a complementary relationship between the leverage and risk-based capital ratios is important to ensure that each type of capital requirement continues to serve as an appropriate counterbalance to offset potential weaknesses of the other.

The 2013 revised capital rule implemented the capital conservation buffer framework (which is only applicable to risk-based capital ratios) and increased risk-based capital requirements more than it increased leverage requirements, reducing the ability of the leverage requirements to act as an effective complement to the risk-based requirements, as they had historically.

As a result, the degree to which banking organizations could potentially benefit from active management of risk- weighted assets before they breach the leverage requirements may be greater.

To account for the increases in stringency in the risk-based capital framework, the agencies calibrated the eSLR standards so that they remain in an effective complementary relationship with the risk-based capital requirements.

The proposed revisions to total leverage exposure were designed to more appropriately capture the exposure of a banking organization's on- and off-balance sheet exposures, which furthers this complementarity.

In adopting the eSLR standards and developing the proposed rule, the agencies considered the combined impact of the eSLR standards and the proposed changes to total leverage exposure.

The agencies noted that, quantitatively, compared to the 2013 revised capital rule, the most important changes in total leverage exposure in the proposed rule are:

(i) The proposed use of standardized CCFs for certain off- balance sheet activities, which should lead to a reduction in total leverage exposure, and

(ii) the proposed treatment of sold credit derivatives, which should lead to an increase in total leverage exposure.

However, the actual total leverage exposure under the proposed rule would be especially sensitive to the volume of sold credit derivative activities and would be dependent on whether those activities are hedged in a manner recognized under the proposed rule.

As discussed in the proposed rule, supervisory estimates suggested that the proposed changes to the definition of total leverage exposure would result in an approximately 8.5 percent aggregate increase in total leverage exposure across the BHCs subject to the eSLR standards, relative to the definition of total leverage exposure in the 2013 revised capital rule.

Based on current estimates, total leverage exposure across the eight BHCs subject to the eSLR standards would increase by an average of 2.6 percent under the proposed rule as compared to the definition of total leverage exposure under the 2013 revised capital rule.

In both analyses, on an individual firm basis, for some BHCs subject to the eSLR standards, total leverage exposure increased, while for others it decreased, relative to the definition of total leverage exposure in the 2013 revised capital rule.

The decline from an 8.5 percent to a 2.6 percent aggregate increase reflects a lower estimate of the impact of including the notional amount of credit derivatives, resulting from trade compression and possibly more offsetting of credit derivatives in response to the proposed rule.

Using data as of the second quarter of 2014, the agencies estimate that BHCs subject to the eSLR standards will need to raise, in the aggregate, approximately $14.5 billion of tier 1 capital to exceed a 5 percent supplementary leverage ratio under the definition of total leverage exposure in the final rule, over and above the amount BHCs subject to the eSLR standards would have needed to raise under the definition of total leverage exposure in the 2013 revised capital rule.

This is less than the incremental effect estimated in the proposed rule of $46 billion, based on data as of the fourth quarter of 2013.

The change is the result of capital raising by BHCs subject to the eSLR standards, who increased their tier 1 capital by 9.3 percent, in combination with a 2.9 percent increase in total leverage exposure, between the fourth quarter of 2013 and the second quarter of 2014.

Based on these considerations, the agencies believe that the revisions to the definition of total leverage exposure should not affect the calibration of the 5 and 6 percent supplementary leverage ratio thresholds under the eSLR standards.

B. Total Leverage Exposure Definition

The proposed rule would have adjusted the measure of total leverage exposure to more appropriately capture the exposure of a banking organization's on- and off-balance sheet items.

For example, the proposed rule would have included in total leverage exposure the effective notional principal amount of credit derivatives and other similar instruments through which a banking organization provides credit protection (sold credit protection), which has the effect of increasing total leverage exposure associated with these credit derivatives, and would have introduced graduated CCFs for off-balance

sheet exposures, which would have reduced total leverage exposure with respect to these items.

The proposed rule also would have modified the total leverage exposure calculation for derivative contracts and repo-style transactions in a manner that is intended to ensure that the supplementary leverage ratio appropriately reflects the economic exposure of these activities.

1. Exclusion of Certain On-balance Sheet Assets

Many commenters expressed the view that the definition of total leverage exposure should exclude certain categories of assets.

Specifically, commenters encouraged the agencies to exclude from total leverage exposure highly liquid assets, such as cash, claims on central banks, and sovereign securities, particularly U.S. Treasuries.

Some commenters expressed concern that including highly liquid and low- risk assets in total leverage exposure could have negative consequences, including the creation of disincentives for banking organizations to engage in prudent risk management practices.

According to commenters, total leverage exposure as proposed could incentivize banking organizations to abandon lower-margin business lines in favor of higher-risk, higher-return activities, in order to increase return on equity.

Some commenters also expressed the view that the inclusion of the full value of highly liquid and low-risk assets in total leverage exposure would conflict with the agencies' proposed liquidity coverage ratio (LCR) rulemaking, which requires holdings of high-quality liquid assets (HQLA).

These commenters maintained that the proposed changes to the supplementary leverage ratio would increase capital requirements for banking organizations that have been increasing their inventories of HQLA in an effort to comply with the LCR requirements because the proposed supplementary leverage ratio would effectively penalize HQLA with higher capital charges per unit of risk.

Certain commenters also expressed the view that the inclusion of low-risk assets in the definition of total leverage exposure penalizes core aspects of the custody bank business model, including the intermediation of high-volume, low- risk, low-return financial activities and broad reliance on essentially riskless assets, notably central bank deposits.

Specifically, these commenters recommended that the final rule exclude deposits with central banks (including Federal Reserve Banks) from total leverage exposure in order to accommodate increases in banking organizations' assets, both temporary and sustained, that occur as a result of macroeconomic factors and monetary policy decisions, particularly during periods of financial market stress.

Additionally, these commenters recommended that the agencies adjust total leverage exposure for central bank deposits associated with excess amounts of operationally-linked client deposit balances.

Under this approach, a banking organization would be permitted to deduct its excess operational deposits placed with a central bank from its measure of total leverage exposure, subject to a standardized supervisory factor and excluding any balances resulting from reserve or other similar requirements.

Several commenters noted that custody banks, which can experience volatility in deposits tied to day-to-day activities, could potentially take actions, such as limiting payment, clearing, and settlement activities, or placing unilateral restrictions on deposit inflows, if the definition of total leverage exposure is unchanged from the proposed rule.

Some commenters also noted that the daily averaging provision in the NPR, which would have required that banking organizations calculate quarter-end total leverage exposure based on the daily average of exposure amounts throughout the quarter, would not significantly address these concerns.

Alternatively, some commenters suggested that the agencies discount or cap the amount of such assets included in total leverage exposure.

In particular, they suggested that the agencies could set certain threshold levels for particular low-risk assets relative to total assets where any holdings of such low-risk assets beyond this threshold would be excluded from total leverage exposure.

In addition, some commenters recommended that the agencies preserve flexibility during periods of financial market stress, particularly to address a large, temporary increase in a banking organization's cash account that could lead to a sharp decrease in the banking organization's supplementary leverage ratio.

The agencies addressed similar comments in the final rule implementing the eSLR standards.

In general, the supplementary leverage ratio is designed to require a banking organization to hold a minimum amount of capital against total assets and off- balance sheet exposures, regardless of the riskiness of the individual assets.

Excluding central bank deposits would not be consistent with this principle.

In response to commenters' concern that total leverage exposure as proposed could incentivize banking organizations to hold higher-risk, higher-return assets, the agencies maintain that the complementary relationship between the leverage and risk-based capital ratios is designed to mitigate any regulatory capital incentives for banking organizations to inappropriately increase their risk profile in response to a strict supplementary leverage ratio.

If the supplementary leverage ratio were to become the binding regulatory capital ratio for a particular banking organization, and that banking organization were to acquire more higher-risk assets, risk-weighted assets should increase until the risk-based capital framework becomes binding.

Conversely, if a binding risk-based capital ratio induces an institution to expand portfolios whose risk is insufficiently addressed by the risk- based

capital framework, its total leverage exposure would increase until the supplementary leverage ratio would become binding.

Regardless of which framework is binding, banking organizations could potentially increase their holdings of assets whose risks are not adequately addressed by the binding framework.

In this regard, the agencies note the importance of the complementary nature of the two frameworks in counterbalancing such incentives.

Moreover, the agencies observe that banking organizations choose their asset mix based on a variety of factors, including yields available relative to the overall cost of funds, the need to preserve financial flexibility and liquidity, revenue generation and the maintenance of market share and business relationships, and the likelihood that principal will be repaid, in addition to regulatory capital considerations.

In response to commenters' concern that the inclusion of the full value of highly liquid and low-risk assets in total leverage exposure would conflict with the agencies' proposed LCR rulemaking, the agencies believe that while the supplementary leverage ratio requires capital to be held against the HQLA required by the LCR, there are actions a banking organization could take to address an LCR HQLA shortfall, such as reducing short-term funding sources or off-balance sheet requirements, that would not necessarily increase a firm's capital requirement under the supplementary leverage ratio.

The agencies believe that, in many ways, the LCR and the supplementary leverage ratio are complementary.

In isolation, the supplementary leverage ratio may encourage firms to take greater liquidity risk by purchasing less liquid assets that have a greater yield.

In contrast, the LCR, in isolation, may allow the firm to rely on substantial short-term funding as long as the firm also holds HQLA.

The two measures together provide assurance that firms that rely substantially on short-term funding hold appropriate capital and liquid assets.

The agencies understand the commenters' observation that the custody banks, which act as intermediaries in high-volume, low-risk, low-return financial activities, may experience increases in assets that occur as a result of macroeconomic factors and monetary policy decisions, particularly during periods of financial market stress.

The agencies also recognize that certain monetary policy actions, such as quantitative easing, create additional reserve balances that banking organizations must add to their balance sheets, thereby impacting firms' leverage ratios.

Because the supplementary leverage ratio is insensitive to risk, it is possible that banking organizations' costs of holding low-risk, low-return assets—such as reserve balances—could increase if such ratio were to become the binding regulatory capital constraint.

However, as mentioned above, the agencies observe that banking organizations consider many factors beyond regulatory capital requirements, such as yields available relative to the overall cost of funds, the need to preserve financial flexibility and liquidity, revenue generation and the maintenance of market share and business relationships, and the likelihood that principal will be repaid, when choosing an appropriate asset mix.

With regard to the commenters' request to exclude certain low-risk assets, such as cash, central bank deposits, or sovereign securities from total leverage exposure, the agencies believe that excluding broad categories of assets from the denominator of the supplementary leverage ratio is generally inconsistent with the goal of limiting leverage without differentiating across asset types.

Such exclusions could, for example, allow a banking organization to take on additional debt without increasing its supplementary leverage ratio requirements (if the proceeds from such debt are invested in certain types of assets).

The agencies therefore believe that all of a banking organization's assets, including those that are viewed as low-risk assets, should be reflected in the supplementary leverage ratio.

This makes the supplementary leverage ratio more difficult to arbitrage and results in a simpler calculation.

Furthermore, the agencies do not believe that there is sufficient justification to treat certain low-risk assets, such as central bank deposits, differently in the denominator of the supplementary leverage ratio than other low-risk assets, such as cash or U.S. Treasuries.

In addition, retaining the treatment as proposed better aligns the supplementary leverage ratio with the Basel III leverage ratio, which promotes international consistency in the calculation of total leverage exposure.

Accordingly, the agencies have decided to not exempt or limit any categories of balance sheet assets from the denominator of the supplementary leverage ratio in the final rule.

Thus, all categories of assets, including cash, U.S. Treasuries, and deposits at the Federal Reserve, are included in the denominator of the supplementary leverage ratio.

The agencies note that, under the 2013 revised capital rule, the agencies reserved the authority to consider whether average total consolidated assets or total leverage exposure for a banking organization's supplementary leverage ratio is appropriate given the banking organization's exposures or its circumstances, and the agencies may require adjustments to those amounts.

The final rule clarifies that this authority would be applicable by replacing the term "leverage ratio exposure amount" with the defined term "total leverage exposure."

2. Cash Variation Margin Associated With Derivative Transactions

The proposed rule would have revised the circumstances under which a banking organization could offset cash collateral received from a counterparty against any positive mark-to-fair value of a derivative contract for purposes of measuring total leverage exposure.

Under the 2013 revised capital rule, total leverage exposure includes a banking organization's on-balance sheet assets, including the carrying value, if any, of derivative contracts on the banking organization's balance sheet.

For the purpose of determining the carrying value of derivative contracts, U.S. generally accepted accounting principles (GAAP) provide a banking organization the option to reduce any positive mark-to-fair value of a derivative contract by the amount of any cash collateral received from the counterparty, provided the relevant GAAP criteria for offsetting are met (the GAAP offset option).

Similarly, under the GAAP offset option, a banking organization has the option to offset the negative mark-to-fair value of a derivative contract with a counterparty by the amount of any cash collateral posted to the counterparty.

Under the 2013 revised capital rule, regardless of whether a banking organization uses the GAAP offset option to calculate the on-balance sheet amount of derivative contracts, a banking organization must include any on-balance sheet assets arising from the receipt of cash collateral from the counterparty in its total leverage exposure.

Under the proposed rule, if a banking organization applies the GAAP offset option to determine the carrying value of its derivative contracts, the banking organization would be required to reverse the effect of the GAAP offset option for purposes of determining total leverage exposure, unless the cash collateral recognized to reduce the mark-to-fair value is cash variation margin that satisfies all of the following conditions:

(1) For derivative contracts that are not cleared through a qualifying central counterparty (QCCP), the cash collateral received by the recipient counterparty is not segregated;

(2) Variation margin is calculated and transferred on a daily basis based on the mark-to-fair value of the derivative contract;

(3) The variation margin transferred under the derivative contract or the governing rules for a cleared transaction is the full amount that is necessary to fully extinguish the current credit exposure amount to the counterparty of the derivative contract, subject to the threshold and minimum transfer amounts applicable to the counterparty under the terms of the derivative contract or the governing rules for a cleared transaction;

(4) The variation margin is in the form of cash in the same currency as the currency of settlement set forth in the derivative contract, provided that, for purposes of this paragraph, currency of settlement means any currency for settlement specified in the qualifying master netting agreement, the credit support annex to the qualifying master netting agreement, or in the governing rules for a cleared transaction; and

(5) The derivative contract and the variation margin are governed by a qualifying master netting agreement between the legal entities that are the counterparties to the derivative contract or by the governing rules for a cleared transaction.

The qualifying master netting agreement or the governing rules for a cleared transaction must explicitly stipulate that the counterparties agree tosettle any payment obligations on a net basis, taking into account any variation margin received or provided under the contract if a credit event involving either counterparty occurs.

With respect to the potential reduction of gross fair value amounts for cash variation margin, one commenter expressed the view that the calculation of total leverage exposure should follow the treatment of cash collateral under IFRS rather than GAAP.

The agencies believe that the netting criteria specified in the proposal, which were developed without regard to whether a banking organization applies GAAP or IFRS, produce an appropriate measure of a banking organization's exposure to derivative transactions.

With respect to the first proposed criterion, commenters expressed concern that a banking organization that posts cash variation margin to a counterparty that is not a QCCP may not know whether that counterparty has segregated the cash variation margin that it has received.

These commenters recommended that the agencies clarify in the final rule that a banking organization posting cash variation margin may presume that a counterparty has not segregated the cash variation margin received unless required to do so pursuant to applicable legal requirements or under contractual terms.

In the final rule, the agencies are clarifying that unless segregation is required by law, regulation, or any agreement with the counterparty, a banking organization that posts cash variation margin to a counterparty may assume that its counterparty has not segregated the cash variation margin it has received for purposes of meeting this criterion.

The agencies also note that "not segregated" in this context means that the cash variation margin received is commingled with the banking organization's other funds.

In other words, the counterparty that receives the cash variation margin should have no unique restrictions on its ability to use the cash received (e.g., the banking organization may use the cash variation margin received similar to other cash held by the banking organization).

With respect to the second criterion, the agencies received a question about the calculation and transfer of cash variation margin on a daily basis.

The commenter asked whether the second criterion would be met for certain categories of derivative transactions, such as exchange-traded options and energy derivatives, where variation margin may not be exchanged daily, but is exchanged on a regular basis.

In addition, buyers of exchange-traded options do not receive variation margin from the options CCP, who holds the margin collected from option sellers during the course of the contract.

For purposes of meeting the second criterion, derivative positions must be valued daily and cash variation margin must be transferred daily to the counterparty or to the counterparty's account when the threshold and daily minimum transfer amounts are satisfied according to the terms of the derivative contract.

With respect to the third proposed criterion, commenters expressed the view that there may be occasional short- term differences between the amount of the variation margin provided and the mark-to-fair value of derivative contracts.

For example, it is common practice for a morning margin call to be based on the mark-to-fair value of a derivative contract based on the previous end-of-business day's valuation.

The commenters recommended that the agencies permit such small, temporary differences between the amount of variation margin provided and the current mark-to-fair value, so long as it is clear that the contract governing such transactions requires variation margin for the full amount of the current credit exposure.

The agencies agree with the commenters that such temporary differences should not invalidate recognition of the variation margin already received, and as such, a morning margin call based on the mark from the end of the previous day should be considered to satisfy this criterion.

Therefore, the agencies are clarifying that cash variation margin exchanged on the morning of the subsequent trading day would meet the third criterion for cash variation margin.

As noted in the preamble to the proposed rule, the regular and timely exchange of cash variation margin helps to protect both counterparties from the effects of a counterparty default.

The proposed conditions under which cash collateral may be used to offset the amount of a derivative contract were developed to ensure that such cash collateral is, in substance, a form of pre- settlement payment on a derivative contract.

This approach is consistent with the design of the supplementary leverage ratio, which generally does not permit banking organizations to use collateral to reduce exposures for purposes of calculating total leverage exposure.

The proposed conditions also ensure that the counterparties calculate their exposures arising from derivative contracts on a daily basis and transfer the net amounts owed, as appropriate, in a timely manner.

Therefore, with the clarifications noted above, the agencies are finalizing the criteria as proposed for permitting the use of cash variation margin to offset the mark-to-fair value of derivative contracts.

3. Credit Derivatives

Under the 2013 revised capital rule, a banking organization would include in total leverage exposure the potential future exposure (PFE) associated with a credit derivative using the current exposure methodology (CEM) as specified in section 34 of the 2013 revised capital rule.

The proposed rule would have required a banking organization to include in total leverage exposure the effective notional principal amount (that is, the apparent or stated notional principal amount multiplied by any multiplier in the derivative contract) of sold credit protection, but would have permitted the banking organization to reduce the effective notional principal amount of sold credit protection with credit protection purchased under certain conditions.

Specifically, a banking organization would be permitted to reduce the effective notional principal amount of sold credit protection on a single exposure by the effective notional principal amount of a credit derivative or similar instrument through which the banking organization has purchased credit protection (purchased credit protection), provided that the purchased credit protection has a remaining maturity that is equal to

or greater than the remaining maturity of the sold credit protection, and that the reference exposure of the purchased credit protection refers to the same legal entity and ranks pari passu with, or is junior to, the reference exposure of the sold credit protection.

In addition, the NPR would have permitted a banking organization to reduce the effective notional principal amount of sold credit protection that references a single reference exposure using purchased credit protection that references multiple exposures if the purchased credit protection is economically equivalent to buying credit protection separately on each of the individual reference exposures of the sold credit protection.

For example, this would be the case if a banking organization were to purchase credit protection on an entire securitization structure or on an entire index that includes the reference exposure of the sold credit protection.

However, if a banking organization purchases credit protection that references multiple exposures, but the purchased credit protection is not economically equivalent to buying credit protection separately on each of the individual reference exposures (for example, through an nth-to-default credit derivative or a tranche of a securitization), the proposed rule would not have allowed the banking organization to reduce the effective notional principal amount of the sold credit protection that references a single exposure.

Under the NPR, to reduce the effective notional principal amount of sold credit protection that references multiple exposures, such as an index (e.g., the CDX) or a tranche of an index or securitization, the reference exposures of the purchased credit protection would need to refer to the same legal entities and rank pari passu with the reference exposures of the sold credit protection.

The purchased credit protection also would need to have a remaining maturity that is equal to or greater than the remaining maturity of the sold credit protection.

In addition, the level of seniority of the purchased credit protection would need to rank pari passu with the level of seniority of the sold credit protection.

Therefore, offsetting would be recognized only when all of the reference exposures and the level of subordination of protection sold and protection purchased are identical.

For example, a banking organization may reduce the effective notional principal amount of the sold credit protection on an index, or a tranche of an index, with purchased credit protection on such index, or a tranche of equal seniority of such index, respectively.

In general, commenters expressed the view that the criteria in the proposed rule under which a banking organization could reduce the effective notional principal amount of sold credit protection with purchased credit protection were too narrow and would result in an overstatement of the actual economic exposure in some cases.

For example, commenters recommended that purchased credit protection that has a residual tenor which is sufficiently long-term be considered eligible to reduce the effective notional amount of sold credit protection if all of the other criteria are met.

These commenters expressed the view that such an approach would be appropriate because it would generally disqualify short-term purchased credit protection from reducing the effective notional amount of sold credit protection.

In addition, these commenters recommended that purchased credit protection on a junior tranche of a securitization be allowed to offset protection sold on a senior tranche of the same securitization.

One comment letter recommended a more restrictive approach, suggesting that offsetting sold credit protection against purchased credit protection should only be allowed if the protection seller has a very high credit rating and is not affiliated with the reference entity.

The agencies believe that the criteria in the proposed rule strike a balance between recognizing the amount of sold credit protection and ensuring that the offsetting purchased credit protection appropriately matches the risks of the underlying reference exposure of the sold credit protection.

Further, the proposed criteria for offsetting sold credit protection are generally consistent with the way banking organizations seek to limit their exposure to the underlying reference exposures of sold credit protection by purchasing credit protection on the same or similar exposures of the same or longer maturity.

The proposed criteria result in a significant reduction of the effective notional amount of sold credit protection, while capturing the effective notional amount of sold credit protection that a banking organization has not fully hedged.

The proposed criteria are also consistent with the Basel III leverage ratio standards.

With regard to commenters' suggestions of additional adjustments and modifications to these criteria, changing the proposed criteria for offsetting sold credit protection would complicate the calculation of total leverage exposure and the impact of any such modifications would likely be immaterial.

With regard to the comment that the criteria for reducing the effective notional amount of sold credit protection should be stricter, the agencies believe that restricting the criteria further would unduly penalize banking organizations that have significantly reduced their exposure to the underlying reference exposures by purchasing credit protection.

Therefore, the final rule does not modify the proposed criteria to reduce the effective notional amount of sold credit protection.

Commenters also recommended allowing any purchased credit protection which covers the entirety of the subset of exposures covered by the sold credit protection to reduce the effective notional amount of sold credit protection.

Specifically, commenters sought clarity regarding a situation in which a banking organization has purchased and sold credit protection on overlapping portions of the same reference index or securitization, but where the purchased credit protection does not cover the entirety of the portion of the index or securitization on which the banking organization has sold credit protection.

The agencies note that the final rule does permit a banking organization that has purchased and sold credit protection on overlapping portions of the same reference index, but where the purchased credit protection does not cover the entirety of the portion of the index or securitization on which the banking organization has sold credit protection, to offset the sold credit protection by the overlapping portion of purchased credit protection.

For example, if a banking organization has sold credit protection on the 3–7 percent tranche(s) of an index and purchased credit protection on the 5–10 percent tranche(s) of the same index, the banking organization may offset the 5–7 percent portion of the sold credit protection, assuming all of the other relevant criteria are met.

In such situations, offsetting may be recognized because, in accordance with the final rule, all of the reference exposures and the level of subordination of sold credit protection and purchased credit protection are identical for the overlapping portion of purchased and sold credit protection.

Commenters recommended that the agencies clarify that clearing member banking organizations are not required to include the effective notional amount of sold credit protection cleared on behalf of a client though a CCP, and that such a derivative transaction, or other similar instrument, related to the sold credit protection should instead be included in total leverage exposure of the clearing member banking organization in the same manner as other cleared derivatives.

The agencies are clarifying that the effective notional principal amounts of sold credit protection that are cleared for clearing member clients through CCPs are not included in a clearing member banking organization's total leverage exposure.

In addition, the clearing member banking organization would include such a derivative transaction, or other similar instrument, related to the sold credit protection in its total leverage exposure in the same manner as other cleared derivative transactions (that is, if the clearing member banking organization guarantees the performance of a clearing member client with respect to a cleared transaction, the clearing member banking organization would treat the exposure to the clearing member client as a derivative contract).

In addition, under the proposed rule, for sold credit protection, a banking organization would have accounted for the notional amount of sold credit protection in total leverage exposure through the effective notional principal amount, as well as through CEM (that is, the current credit exposure and the PFE), as described above.

In the proposed rule, a banking organization would have been permitted to adjust the PFE for sold credit protection to avoid double-counting the notional amounts of these exposures.

For example, if the sold credit protection was governed by a qualifying master netting agreement, a banking organization would have been permitted to adjust the PFE for sold credit protection covered by the qualifying master netting agreement.

However, a banking organization would have been allowed to adjust only the amount Agross of the PFE calculation for sold credit derivatives and would not have been allowed to adjust the net-to- gross ratio (NGR) of the PFE calculation.

Finally, a banking organization that elected to adjust the PFE for sold credit derivatives would have been required to do so consistently over time.

The agencies did not receive any comments on the PFE adjustment, and are therefore finalizing this aspect of the rule substantively as proposed.

4. Repo-Style Transactions

Under the 2013 revised capital rule, total leverage exposure includes the on- balance sheet carrying value of repo- style transactions, but not the related off-balance sheet exposure for such transactions.

The proposed rule set forth a revised treatment of repo-style transactions, including the conditions under which a banking organization would be permitted to measure the exposure of repo-style transactions using the carrying value for the transactions (using the GAAP offset for repo-style transactions, as described below), rather than the gross value of all receivables due from a counterparty.

The proposed rule also specified the treatment for a security-for-security repo-style transaction, a repurchase or reverse repurchase transaction, or a securities borrowing or lending transaction that is treated as a sale for accounting purposes, and the counterparty credit risk component of repo-style transactions.

The proposed rule also clarified the calculation of total leverage exposure for repo-style transactions where a banking organization acts as an agent.

a. Criteria for Recognizing the GAAP Offset for Repo-style Transactions

For purposes of determining the on- balance sheet carrying value of a repo- style transaction, GAAP permits a banking organization to offset the gross values of receivables due from a counterparty under reverse repurchase agreements by the amount of the payments due to the same counterparty (that is, amounts recognized as payables to the same counterparty under repurchase agreements), provided the relevant accounting criteria are met (GAAP offset for repo-style transactions).

The proposed rule specified the criteria for when a banking organization would have been required to reverse the GAAP offset for repo-style transactions for the purpose of calculating total leverage exposure.

If a banking organization entered into repurchase and reverse repurchase transactions with the same counterparty and applied the GAAP offset for repo- style transactions, but the transactions did not meet the criteria

described below, the banking organization would have been required to replace the net on-balance sheet assets of the reverse repurchase transactions determined according to GAAP, if any, with the gross value of receivables for those reverse repurchase transactions.

Those criteria are:

(1) The offsetting transactions have the same explicit final settlement date under their governing agreements;

(2) The banking organization's right to offset the amount owed to the counterparty with the amount owed by the counterparty is legally enforceable in the normal course of business and in the event of receivership, insolvency, liquidation, or similar proceeding; and

(3) Under the governing agreements, the counterparties intend to settle net, settle simultaneously, or settle according to a process that is the functional equivalent of net settlement.

That is, the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date.

To achieve this result, both transactions must be settled through the same settlement system and the settlement arrangements must be supported by cash or intraday credit facilities intended to ensure that settlement of both transactions will occur by the end of the business day, and the settlement of the underlying securities does not interfere with the net cash settlement.

With respect to the first proposed criterion, commenters expressed the view that the agencies clarify or revise the final rule to provide that undated repo-style transactions (sometimes referred to as "open" transactions), which can be unwound unconditionally at any time by either counterparty, may be treated as having an effective one-day maturity.

Because the proposed rule referred to "explicit" settlement dates, it

would not have permitted receivables or payables from "open" transactions to be offset against payables or receivables from overnight transactions (or against other "open" transactions).

The criterion limiting offsetting to those repo-style transactions that have the "same explicit final settlement date" is consistent both with current accounting standards and with the BCBS 2014 revisions to the Basel III leverage ratio.

This criterion helps to ensure that the counterparties agree in advance what the settlement date for a repo-style transaction would be, and thus helps a banking organization manage its counterparty exposure, including the net amount owed.

To promote consistency in the treatment of repo-style transactions, and to ensure banking organizations do not understate their actual exposure to repo-style transactions for the purpose of calculating total leverage exposure, the agencies continue to believe that explicit identical settlement dates established at the origination of repo- style transactions should be a criterion for offsetting repo-style transactions in the final rule.

Therefore, the agencies are finalizing this aspect of the rule as proposed.

With respect to the third criterion, commenters recommended deleting the proposed requirement that "settlement of the underlying securities does not interfere with the net cash settlement."

The commenters expressed the view that the purpose of this requirement is unclear.

In the final rule the agencies are clarifying that this criterion requires that the settlement of the underlying securities be subject to a settlement mechanism that results in the functional equivalence of net settlement.

In other words, the cash flows of the transactions must be equivalent, in effect, to a single net amount on the settlement date.

To achieve such equivalence, all transactions must be settled through the same settlement system, and any settlement system used to settle the

transactions must not require all securities to have successfully settled before settling any net cash obligations.

The settlement system's procedures must provide that the failure of any single securities transaction in the settlement system should only delay the matching cash leg (payment) or create an obligation to the settlement system, supported by an associated credit facility.

The requirement that settlement of the underlying securities does not interfere with the net cash settlement is not intended to exclude any settlement mechanism, such as a delivery-versus- payment or other mechanism, if it meets these functional requirements.

If a settlement system's procedures allow for all of the above, then the third criterion would be met.

If the failure of the securities leg of a transaction in such a system persists at the end of the settlement period, however, then this transaction and its matching cash leg must be split out from the netting set and treated gross for the purposes of total leverage exposure.

In the proposal, the agencies requested comment on the operational implications of the proposed netting criteria for repo-style transactions compared to GAAP, and the magnitude of the change in total leverage exposure for these transactions compared to GAAP.

The agencies also asked about the potential costs of developing the necessary systems to offset amounts recognized as receivables due from a counterparty under reverse repurchase agreements.

The agencies did not receive responses to these questions.

One comment letter stated that if any additional costs exist, those would not be a valid reason for not requiring the netting criteria as a pre-requisite for the preferential capital treatment for netting.

b. Treatment of Security-for-Security Repo-style Transactions

The proposed rule specified how a banking organization would have treated security-for-security repo-style transactions for purposes of calculating total leverage exposure.

Under GAAP, in a security-for-security repo-style transaction, the receiver of a security lent (a securities borrower) does not include the security borrowed on its balance sheet provided that the lender has not defaulted under the terms of the transaction.

A security that a securities borrower transferred to the lender (a securities lender) as collateral would remain on the securities borrower's balance sheet.

Consistent with GAAP, under the proposed rule, a securities borrower would have included a security that is transferred to a securities lender in its total leverage exposure, but the NPR would not have required the securities borrower to adjust its total leverage exposure related to such a transaction, unless and until the security borrower sold the security or the securities lender defaulted.

The agencies did not receive any comments on the proposed treatment from the securities borrower's perspective.

Therefore, the agencies are adopting the treatment in a security- for - security repo- style transaction for the securities borrower as proposed.

Under GAAP, from a securities lender's perspective, a security received as collateral from a securities borrower is included on the security lender's balance sheet as an asset.

In addition, a securities lender also must continue to include the security that it lent on its balance sheet if the transaction is treated as a secured borrowing.

Under the proposal, in a security-for-security repo-style transaction, a securities lender would have been allowed to exclude the security received as collateral from total leverage exposure, unless and until the securities lender sells or re-hypothecates the security.

If the securities lender sold or re- hypothecated the security, the securities lender would have been required to include the amount of cash received or, in the case of re-hypothecation, the value of the security pledged as collateral in its total leverage exposure.

Commenters expressed concern that the proposed treatment of security-for security transactions would not achieve consistency across differing accounting frameworks in periods subsequent to a sale or re-hypothecation by a securities lender, and recommended revising the proposed rule to permit banking organizations acting as securities lenders to reduce total leverage exposure by the value of the securities received in a security-for-security repo- style transaction, regardless of whether such banking organization sold or re- hypothecated the securities received.

The agencies have decided not to change the proposal in response to these comments.

The proposed approach, which is consistent with international standards, was designed to ensure that a securities lender would not have included both a security lent and a security received in its total leverage exposure, unless the securities lender sold or re-hypothecated the security received.

In addition, the agencies believe the proposed treatment appropriately captures the exposure associated with a security that has been re-hypothecated because a banking organization is obligated to return or repurchase the security at a later date.

Further, the agencies note that pursuant to the BCBS 2014 revisions, total leverage exposure would include amounts associated with the sale or re-hypothecation of collateral by a securities lender, thereby eliminating the effect of any differences in accounting frameworks.

The agencies are therefore finalizing this aspect of the rule as proposed.

c. Repurchase and Securities Lending Transactions That Qualify for Sales Treatment Under U.S. GAAP

The proposed rule specified the treatment for a repurchase or reverse repurchase transaction or a securities borrowing or lending transaction that qualifies for sales treatment under U.S. GAAP (repurchase or securities lending transaction that qualifies for sales treatment under U.S. GAAP).

The proposed rule would have required a banking organization to add the value of securities sold under such a repurchase or securities lending transaction that qualifies for sales treatment under U.S. GAAP to total leverage exposure for as long as the transaction is outstanding.

The agencies did not receive any comments on this particular aspect of the proposed rule and are finalizing this aspect of the rule as proposed.

The agencies are providing clarification of the treatment of a forward agreement associated with a repurchase or securities lending transaction that qualifies for sales treatment under U.S. GAAP.

If a repurchase or securities lending transaction qualifies for sales treatment under U.S. GAAP, a banking organization would generally record an associated forward purchase agreement or forward sale agreement, which may be treated as a derivative exposure under GAAP.

The replacement cost and PFE associated with this derivative exposure, in combination with the value of the security sold may overstate the actual exposure in total leverage exposure of such a repurchase or securities lending transaction that qualifies for sales treatment under U.S. GAAP.

Therefore, the PFE related to a forward agreement associated with a repurchase or securities lending transaction that qualifies for sales treatment under U.S. GAAP may be excluded from total leverage exposure.

Moreover, a forward agreement associated with a repurchase or securities lending transaction that qualifies for sales treatment under U.S. GAAP

should not be included in total leverage exposure as an off-balance sheet exposure subject to a CCF.

d. Counterparty Credit Risk Measure

The proposed rule also included a counterparty credit risk measure in total leverage exposure to capture a banking organization's exposure to its counterparty in repo-style transactions.

To determine the counterparty exposure for a repo-style transaction, including a transaction in which a banking organization acts as an agent for a customer and indemnifies the customer against loss, the banking organization would subtract the fair value of the instruments, gold, and cash received from a counterparty from the fair value of any instruments, gold, and cash lent to the counterparty.

For repo-style transactions that are not subject to a qualifying master netting agreement or that are not cleared, the counterparty exposure measure would be calculated on a transaction-by-transaction basis.

However, if a qualifying master netting agreement were in place, or the transactions were cleared, the banking organization would be able to net the total fair value of instruments, gold, and cash lent to a counterparty against the total fair value of instruments, gold, and cash received from the same counterparty across all those transactions.

The agencies did not receive any comments on this part of the proposed rule and are adopting it as proposed.

The proposed rule provided that where a banking organization acts as an agent for a repo-style transaction and provides a guarantee (indemnity) to a customer with regard to the performance of the customer's counterparty that is greater than the difference between the fair value of the security or cash lent and the fair value of the security or cash borrowed, the banking organization would have been required to include the amount of the guarantee that is greater than this difference in its total leverage exposure.

The agencies did not receive any comments on this part of the proposed rule and are adopting it as proposed.

e. Repo-style Transactions Cleared Through CCPs

One commenter asked the agencies to clarify the proposed rule with regard to repo-style transactions cleared through CCPs, when a banking organization acting as an agent offers indemnifications to the client.

According to the commenter, a banking organization that clears repo-style transactions through a CCP is generally required to post cash collateral to the CCP.

The commenter stated that this would likely result in a larger counterparty exposure amount added to total leverage exposure than a similar repo-style transaction executed as a bilateral trade, and would discourage the clearing of repo-style transactions.

However, the commenter did not provide any specific proposals to address the disincentives created by the clearing process, and acknowledged that most repo-style transactions are not currently cleared.

The agencies acknowledge that the mechanics of the clearing process currently operate in a manner that results in a larger counterparty exposure than a similar transaction that is not cleared.

The treatment is consistent with the approach for repo-style transactions, and the agencies do not believe that there is sufficient justification to provide a different treatment for repo-style transactions cleared through CCPs for purposes of calculating total leverage exposure.

Therefore, the agencies are not making any revisions in the final rule to address the clearing of repo-style transactions and are finalizing this aspect of the rule as proposed.

5. Off-Balance Sheet Exposures

Under the 2013 revised capital rule, banking organizations must apply a 100 percent CCF to all off-balance sheet items to calculate total leverage exposure, except for unconditionally cancellable commitments, which are subject to a 10 percent CCF.

The NPR would have retained the 10 percent CCF for unconditionally cancellable commitments, but would have replaced the uniform 100 percent CCF for other off-balance sheet items with the CCFs applicable under the standardized approach for risk-weighted assets in section 33 of the 2013 revised capital rule.

Commenters generally supported the adoption of the standardized approach CCFs.

However, some commenters expressed concern over the scope of exposures that are treated as off-balance sheet and, therefore, subject to CCFs.

Some commenters also requested that the agencies revise the CCFs applicable to certain trade finance exposures to effectively decrease the amount of such exposures included in total leverage exposure, specifically to make the treatment of these exposures consistent with the European Union's treatment under the CRD–IV Directive.

Commenters also recommended that the agencies clarify the treatment of certain exposures for purposes of inclusion in total leverage exposure.

For example, commenters suggested that the CCF treatment could result in an overstatement of off-balance sheet exposures, specifically with respect to forward-starting reverse repos and securities borrowing transactions that have been entered into at an agreed rate but have not yet been settled.

Commenters expressed the view that forward-starting reverse repos should be treated as derivative exposures rather than being assigned a CCF, and that the repo-style transaction counterparty credit risk measure should apply only where a qualifying master netting agreement is in place.

Commenters further suggested treating deliverable bond futures and OTC equity forward purchases as derivative exposures rather than off-balance sheet exposures subject to CCFs, because they are trading positions.

These commenters opined that total leverage exposure should exclude "forward forward deposits" that represent the renewal of an existing deposit on its maturity, because including these would double count them.

Alternatively, commenters requested that the agencies clarify that "forward asset purchases," which receive a 100 percent CCF, do not include deliverable bond futures or forward-starting repo transactions.

Under the proposal, off-balance sheet exposures were included in total leverage exposure in a manner consistent with the standardized approach risk-based capital rules.

The treatment of specific instruments depended on the characteristics of those instruments.

For example, an exposure that receives a conversion factor under section 33 of the 2013 revised capital rule would receive the same conversion factor for purposes of calculating total leverage exposure, subject to the minimum 10 percent conversion factor applied to unconditionally cancellable commitments.

Regarding the comment to revise the CCFs applicable to certain trade finance exposures, the agencies have decided not to modify the applicable CCFs for the purposes of calculating total leverage exposure.

The proposed approach incorporates off-balance sheet exposures in total leverage exposure in a straightforward manner consistent with existing regulatory approaches and that already have proven effective.

Thus, the agencies believe that the standardized CCFs, which also are consistent with international standards, are appropriate for measuring total leverage exposure for off-balance sheet exposures.

Accordingly, the agencies have decided to adopt this aspect of the final rule as proposed.

6. Central Clearing of Derivative Transactions

The 2013 revised capital rule provides that a banking organization must include in total leverage exposure the PFE for each derivative contract (or each single-product netting set of such transactions) to which the banking organization is a counterparty calculated in accordance with section 34 of the 2013 revised capital rule, but without regard to any collateral used to reduce risk-based capital requirements pursuant to section 34(b) of the 2013 revised capital rule.

Although cleared transactions are generally addressed in section 35 of the 2013 revised capital rule, section 35 refers to section 34 for the purpose of determining the PFE of cleared derivative transactions.

Thus, for the purpose of measuring total leverage exposure, the PFE for each derivative transaction to which a banking organization is a counterparty, including cleared derivative transactions, should be determined pursuant to section 34.

The proposed rule would have revised the description of total leverage exposure to make this point more clear.

When a clearing member banking organization does not guarantee the performance of the CCP, the clearing member banking organization has no payment obligation to the clearing member client in the event of a CCP default.

In these circumstances, requiring the clearing member banking organization to include an exposure to the CCP in its total leverage exposure would generally result in an overstatement of total leverage exposure.

Therefore, under the proposed rule, and consistent with the Basel III leverage ratio, a clearing member banking organization would not have been required to include in its total leverage exposure an exposure to the CCP for client-cleared transactions if the clearing member banking organization does not guarantee the performance of the CCP to the clearing member client.

However, if a clearing member banking organization does guarantee the performance of the CCP to the clearing member client, then the proposed rule would have required a clearing member banking organization to include an exposure to the CCP for the client- cleared transactions in its total leverage exposure.

One commenter requested that the agencies clarify in the final rule the treatment of a cleared derivative transaction where the clearing member and the clearing member client are affiliates.

Without clarification, the commenter expressed concern that such a situation could result in a double counting of the transaction in the consolidated banking organization's total leverage exposure.

The agencies are clarifying in the final rule that a banking organization may exclude from its total leverage exposure the clearing member's exposure to its clearing member client for a derivative transaction if the clearing member client and the clearing member are affiliates and consolidated on the banking organization's balance sheet.

Commenters also recommended excluding from a clearing member banking organization's total leverage exposure cash provided by a clearing member client as initial margin and held in a segregated account.

The commenters stated that a clearing member banking organization may reflect on its balance sheet both the initial margin passed on to the CCP as well as additional cash initial margin (excess initial margin) requested by the clearing member banking organization but not passed on to the CCP.

Commenters further stated that under the customer asset protection rules issued by the CFTC, the clearing member banking organization may not use any segregated cash posted by a clearing member client to support the clearing member banking organization's own operations.

In effect, commenters asserted that such segregated cash constitutes an asset of the clearing member client.

Commenters also argued that the proposed LCR rules recognize that such segregated cash cannot be treated as an asset available to meet a clearing member banking organization's liquidity needs, even though cash is typically an optimal asset for providing liquidity.

As a general matter the agencies do not believe it is appropriate to exclude segregated or otherwise restricted assets from a banking organization's total leverage exposure and are finalizing this aspect of the rule as proposed.

C. Daily Averaging

The 2013 revised capital rule defines the supplementary leverage ratio as the mean of the ratio of tier 1 capital to total leverage exposure calculated as of the last day of each month in the reporting quarter.

Under the proposed rule, the numerator of the supplementary leverage ratio, tier 1 capital, would have been calculated as of the last day of each reporting quarter, while total leverage exposure, the denominator of the supplementary leverage ratio, would have been calculated as the mean of total leverage exposure calculated daily.

After calculating quarter-end tier 1 capital, banking organizations would have subtracted from the measure of total leverage exposure the applicable deductions from the quarter-end tier 1 capital for purposes of calculating the quarter-end supplementary leverage ratio.

In the NPR, the agencies asked specific questions about the operational burden of the proposed use of average of daily calculations and the burden associated with several alternatives, such as only requiring daily averaging for on-balance sheet assets.

Commenters expressed the view that that the application of daily averaging to off- balance sheet exposures would introduce significant practical complexities with no offsetting compliance benefit.

Several commenters supported an alternative approach in which a banking organization would calculate its total leverage exposure for a quarterly reporting period based on the daily average of on-balance sheet assets and the quarter-end balance or an average of month-end off-balance sheet exposures.

Commenters expressed the view that such an alternative approach strikes an appropriate balance between the accuracy of reported minimum ratios and operational complexity.

Commenters maintained that off-balance sheet exposure volatility is far less significant than on-balance sheet exposure volatility.

In addition, commenters expressed the view that the industry has no operational processes that would permit the daily calculation of certain components of off-balance sheet exposures and that significant systems changes would be required to calculate off-balance sheet exposures on a daily basis.

Commenters also recommended that if the final rule were to require the daily averaging of off- balance sheet exposures, this requirement should be implemented on a phased-in basis to allow more time for banking organizations to comply with the requirement.

While calculating total leverage exposure as the mean of total leverage exposure for each day of the reporting quarter provides the more accurate depiction of total leverage exposure, the agencies recognize the operational burden associated with such calculation for off-balance sheet exposures.

For this reason, the agencies are modifying the calculation of total leverage exposure so that total leverage exposure is calculated as the mean of the on-balance sheet assets calculated as of each day of the reporting quarter, plus the mean of the off-balance sheet exposures calculated as of the last day of each of the most recent three months, minus the applicable deductions under the 2013 revised capital rules.

In addition, the agencies have removed the proposed reference to the calculation of tier 1 capital as of the end of the quarter to avoid the implication that the supplementary leverage ratio is calculated only at the end of the quarter.

For purposes of public disclosures and reporting the supplementary leverage ratio on the applicable regulatory reports, a banking organization would calculate the off- balance exposure component of total leverage exposure as the mean of its off- balance sheet exposures as of the last day of each month in the applicable reporting quarter.

For example, when a banking organization prepares a regulatory report for the quarter ending December 31, it would calculate the mean of its off-balance sheet exposures as of October 31, November 30, and December 31.

The agencies will continue to monitor this issue and may revisit it at a future date if it is determined that monthly calculation of off-balance sheet exposure raises supervisory concerns.

In addition, the agencies are evaluating the calculation methodology for the leverage ratio applicable to all banking organizations and may seek comment on a proposal applicable to advanced approaches banking organizations to align the methodology for calculating on-balance sheet assets for purposes of that leverage ratio and the supplementary leverage ratio in the future.

D. Supervisory Flexibility

Some commenters recommended that the agencies preserve supervisory flexibility during periods of financial market stress, particularly to address a large, temporary increase in a banking organizations' cash that could lead to a sharp decrease in the banking organization's supplementary leverage ratio.

Commenters suggested that the agencies emphasize that falling below the minimum supplementary leverage ratio would not necessarily result in supervisory action, but, at a minimum, would result in heightened supervisory monitoring.

Commenters expressed the view that the agencies should adopt a formal process to address compliance with the supplementary leverage ratio minimums on a case-by-case basis during periods of financial stress.

As previously noted, under the 2013 revised capital rule, the agencies reserved the authority to consider whether the average total consolidated assets or total leverage exposure for a banking organization's supplementary leverage ratio is appropriate given the banking organization's exposures or circumstances, and the agencies may require adjustments to such exposures.

The final rule clarifies that this authority applies to the supplementary leverage ratio calculation by replacing the term "leverage exposure amount" with the defined term "total leverage exposure."

E. Replacement of the Current Exposure Method (CEM)

The NPR proposed to use the current exposure method (CEM) to measure the total leverage exposure associated with derivative contracts.

However, some commenters recommended that the agencies consider the replacement of the CEM with the standardized approach for measuring counterparty credit risk exposures (SA–CCR), recently agreed to by the BCBS though not yet incorporated into its leverage ratio framework.

The commenters requested that the agencies address, in the preamble to the final rule, their intention to consider the replacement of the CEM with the SA–CCR, consistent with any final agreement of the BCBS with regard to the SA–CCR and the Basel III leverage ratio, which is currently under consideration.

In general, the commenters supported adoption of SA–CCR.

The agencies are participating in the BCBS's development of the international leverage ratio standards, and will consider the extent to which any changes should be made to the calculation of total leverage exposure for derivative contracts in the United States once the BCBS has reached an agreement on whether and how to incorporate the SA–CCR into its leverage ratio.

III. Disclosures

The agencies have long supported meaningful public disclosure by banking organizations of their regulatory capital with the goals of disclosing information in a comparable and consistent manner, and improving market discipline.

Consistent with the BCBS 2014 revisions, the agencies are applying additional disclosure requirements related to the calculation of the supplementary leverage ratio to top-tier advanced approaches banking organizations.

The agencies believe that the additional disclosures will enhance the transparency and promote consistency among the disclosures related to the supplementary leverage ratio for all internationally active banking organizations.

Specifically, under the final rule, banking organizations will complete two parts of a supplementary leverage ratio disclosure table.

Part 1 is designed to summarize the differences between the total consolidated accounting assets reported on a banking organization's published financial statements and regulatory reports and the calculation of total leverage exposure.

Part 2 is designed to collect information on the components of total leverage exposure in more detail, similar to the version of FFIEC 101, Schedule A.

The agencies plan to reconsider the regulatory reporting requirements related to the supplementary leverage ratio on FFIEC 101, Schedule A, in the future, to reflect these disclosures and the revisions to the calculation of total leverage exposure.

TABLE 13 TO SECTION 173 OF THE 2013 REVISED CAPITAL RULE—SUPPLEMENTARY LEVERAGE RATIO

	Dollar amounts in thousands			
	Tril	Bil	Mil	Thou
Part 1: Summary comparison of accounting assets and total leverage exposure				
1 Total consolidated assets as reported in published financial statements				
2 Adjustment for investments in banking, financial, insurance or commercial entities that are consolidated for accounting purposes but outside the scope of regulatory consolidation				
3 Adjustment for fiduciary assets recognized on balance sheet but excluded from total leverage exposure				
4 Adjustment for derivative exposures				
5 Adjustment for repo-style transactions				
6 Adjustment for off-balance sheet exposures (that is, conversion to credit equivalent amounts of off-balance sheet exposures)				
7 Other adjustments				
8 Total leverage exposure				
Part 2: Supplementary leverage ratio				
On-balance sheet exposures				
1 On-balance sheet assets (excluding on-balance sheet assets for repo-style transactions and derivative exposures, but including cash collateral received in derivative transactions)				
2 LESS: Amounts deducted from tier 1 capital				
3 Total on-balance sheet exposures (excluding on-balance sheet assets for repo-style transactions and derivative exposures, but including cash collateral received in derivative transactions) (sum of lines 1 and 2)				
Derivative exposures				
4 Replacement cost for derivative exposures (that is, net of cash variation margin)				
5 Add-on amounts for potential future exposure (PFE) for derivative exposures				
6 Gross-up for cash collateral posted if deducted from the on-balance sheet assets, except for cash variation margin				
7 LESS: Deductions of receivable assets for cash variation margin posted in derivative transactions, if included in on-balance sheet assets				
8 LESS: Exempted CCP leg of client-cleared transactions				
9 Effective notional principal amount of sold credit protection				
10 LESS: Effective notional principal amount offsets and PFE adjustments for sold credit protection				
11 Total derivative exposures (sum of lines 4 to 10)				
Repo-style transactions				
12 On-balance sheet assets for repo-style transactions, except include the gross value of receivables for reverse repurchase transactions. Exclude from this item the value of securities received in a security-for-security repo-style transaction where the securities lender has not sold or re-hypothecated the securities received. Include in this item the value of securities that qualified for sales treatment that must be reversed.				
13 LESS: Reduction of the gross value of receivables in reverse repurchase transactions by cash payables in repurchase transactions under netting agreements				
14 Counterparty credit risk for all repo-style transactions				
15 Exposure for repo-style transactions where a banking organization acts as an agent				
16 Total exposures for repo-style transactions (sum of lines 12 to 15)				
Other off-balance sheet exposures				
17 Off-balance sheet exposures at gross notional amounts				
18 LESS: Adjustments for conversion to credit equivalent amounts				
19 Off-balance sheet exposures (sum of lines 17 and 18)				
Capital and total leverage exposure				
20 Tier 1 capital				
21 Total leverage exposure (sum of lines 3, 11, 16 and 19)				
Supplementary leverage ratio				
22 Supplementary leverage ratio	(in percent)			

Consistent with the BCBS 2014 revisions, if a banking organization has material differences between its total consolidated assets as reported in published financial statements and regulatory reports and its reported on-balance sheet assets for purposes of calculating the supplementary

leverage ratio, the banking organization must disclose and explain the source of the material differences.

In addition, if a banking organization's supplementary leverage ratio changes significantly from one reporting period to another, the banking organization must explain the key drivers of the material changes.

Banking organizations must disclose this information quarterly, using the template set forth in Table 13, and make the disclosures publicly available.

In the NPR, the agencies proposed to apply additional disclosure requirements for the calculation of the supplementary leverage ratio to top-tier advanced approaches banking organizations.

One comment letter recommended that the final rule clarify that Part 1, line 2 of the disclosure table include associated entities reflected on a banking organization's balance sheet on the basis of proportionate consolidation.

The commenter noted that it sent the same suggestion to the BCBS to revise the Basel III leverage ratio disclosure requirements.

The agencies proposed disclosure requirements for purposes of reporting of the supplementary leverage ratio consistent with the disclosure requirements in the Basel III leverage ratio.

The agencies decided not to revise the disclosure table in response to this comment because proportionate consolidation generally does not apply to the U.S. banking organizations subject to the supplementary leverage ratio.

If the BCBS reconsiders the Basel III leverage ratio disclosure requirements in light of this comment, then the agencies will consider a revision of the disclosure requirements in the U.S.

Another comment letter stated that the required disclosures do not appear to provide a meaningful breakout of off- balance sheet exposures beyond derivative and repo-style transactions.

The comment letter recommended that the agencies consider a more detailed breakout of off-balance sheet exposures for Part 2, lines 17 and 18.

The agencies believe that the table is sufficiently granular, particularly when viewed in combination with the other regulatory disclosure requirements, including the Call Report and FR Y–9C. Therefore, under the final rule, the agencies are not making any changes to the required disclosures.

Opening speech

Opening speech by Mr Stefan Ingves, Chairman of the Basel Committee on Banking Supervision and Governor of Sveriges Riksbank, at the 18th International Conference of Banking Supervisors, Tianjin, China

Introduction

Good morning and welcome to the 18th International Conference of Banking Supervisors (ICBS).

I'd like to thank our hosts, the China Banking Regulatory Commission (CBRC), and in particular Chairman Shang and his staff for hosting this year's ICBS.

Hosting a conference such as this, with more than 100 supervisory authorities from around the world, is a significant undertaking.

On behalf of everyone here today, I express our deepest appreciation for all the hard work that has gone into organising the ICBS in Tianjin, and congratulate you on doing such an outstanding job.

China joined the Basel Committee in March 2009 - in the midst of what turned out to be a prolonged, far-reaching and complex financial crisis.

Since then, the CBRC and the People's Bank of China have become active members of the Basel Committee and have made valuable contributions during an extremely busy and critical period.

When I think about what the Committee has achieved since the financial crisis, I don't think it would have been possible without the support of the Chinese authorities and the other members that joined the Committee in 2009.

The new members have brought an important new dimension to the Committee table - drawing, of course, on their own experience and perspective as emerging economies.

If the Basel Committee is to achieve its core mission of strengthening regulatory standards and supervisory practices around the globe, then we must make sure that our reach is broad and our work is carried out in an inclusive manner.

In this regard, I am pleased to announce that representatives from Chile, Malaysia and the United Arab Emirates have been invited to join the Basel Committee and attended their first meeting earlier this week.

This is one of many steps that the Committee has taken in recent years to enlarge its geographical outreach and enhance its position as a global standard setter.

The Basel Committee was founded almost 40 years ago to foster cooperation and coordination between central banks and, in doing so, to strengthen the regulation and supervision of international banks.

The principles of cooperation and information-sharing remain as strong and important today as they did when the Committee was founded.

No matter what the regulatory framework or how consistent the implementation - there is no escaping the need for cross-border coordination and cooperation.

Indeed, it is a fundamental element of effective international banking supervision.

The Committee's response to the crisis is a successful illustration of this.

While many of us were managing national responses to the crisis, the Committee came together to develop and implement a revised international regulatory and supervisory framework.

This framework - Basel III - strengthens prudential and supervisory safeguards and, more importantly, helps underpin the economic recovery.

The Basel III package of reforms remains the centrepiece of the G20's regulatory response to the crisis.

This is a reflection of the cooperative and collegiate spirit of the international supervisory community.

The Committee is now close to finalising the Basel III package of reforms.

At its meeting this week, the Committee agreed final modifications to the net stable funding ratio (NSFR), which will be published in the coming weeks.

The NSFR complements the liquidity coverage ratio (LCR) and ensures that a bank maintains a stable funding profile in relation to the composition of its assets and off-balance sheet activities.

After many decades of trying, we now have a global liquidity standard.

It is now more than seven years since the start of the financial crisis.

The biennial ICBS provides an opportunity for us, as an international community, to reflect on the effectiveness of the international standards, to discuss emerging issues, and to explore the challenges ahead.

This ICBS focuses on both the post-Basel III reform agenda and the role of the financial system in promoting economic growth.

However, finalising the Basel III framework does not mean that our policy work is done.

We need to look closely at the regulatory framework, remind ourselves of the reasons why we put these measures in place, and ask whether they are delivering the right outcomes.

The reliability and comparability of risk-based capital ratios

And that leads me to one of the important post-Basel III reform issues: the reliability and comparability of risk-based capital ratios.

Consistency in the implementation of risk-based capital standards is a vital element in strengthening public confidence in regulatory capital ratios and promoting an international level playing field.

The Committee is therefore assessing bank capital ratios with a view to ensuring that they appropriately reflect the risks that banks face.

Our assessments thus far have found significant variation in banks' risk-weighted assets that are not explained by underlying differences in the riskiness of banks' portfolios.

Excessive variation in risk-weighted assets undermines confidence in the risk-based capital framework as a measure of bank safety.

The Committee is well aware of these concerns, and we are taking steps to reduce the variation arising from differences in how banks measure risk.

At the same time, we know that variation in risk-weighted assets can arise from differences in the rules and implementation standards set by national regulators, and so we are also focusing on these areas..

The steps the Committee has taken, and plans to take, to address excessive variation in risk-weighted assets include:

- the introduction of capital floors and benchmarks, and greater restrictions on the scope of banks' internal risk estimates. In this regard, there is recognition that not all risk parameters are suitable for modelling;

- providing clarity on aspects of the Basel framework that are ambiguous, and reducing areas for national discretion;

- strengthening the disclosure requirements relating to risk-weighted assets by amending Pillar 3 of the Basel framework; and

-ensuring consistent implementation of Committee standards and monitoring outcomes of risk-weighted asset variability.

Rather than go into the details of these measures, which I have spoken about previously, let me instead use this opportunity to talk more generally about the outcomes we are trying to achieve.

We sometimes have a tendency to get bogged down in the policy details, and it is easy to lose sight of the overall objective.

At the end of the day, the outcomes we are aiming for are:

- a regulatory framework that promotes effective supervision;

- consistent global implementation;

- effective bank risk measurement and management; and, ultimately,

- a strong, stable and efficient banking system.

Too often, we have not given enough attention to whether the regulatory standards can be implemented consistently, or whether the standards serve to promote, or if they might potentially hinder, the task of day-to-day supervision.

Improving the measurement and management of risk is, of course, a primary objective of bank managers and supervisors, and it is a critical factor for financial system stability.

The Basel Committee spends a lot of time trying to ensure that banks' capital and liquidity buffers are strong enough to keep the system safe and sound.

But a buffer can only be as reliable as the underlying risk measurement and management.

No matter what we do as regulators and supervisors, it is ultimately bank managers that determine whether a bank will be successful.

It is important to recognise the primacy of bank management - that is a fact that should also bear on the design of the regulatory and supervisory framework itself.

With this in mind, how should the regulatory framework be designed in order to promote the outcomes we want to achieve?

This brings me back to the issue of variability in risk-weighted assets.

So, what should be done about it?

Just as the unwarranted variation in risk-weighted assets arises due to a variety of factors, there are a multitude of measures that the Committee is considering to address the issue.

But at the heart of the issue is a debate about the basic design of the regulatory framework itself.

On one side of the debate is the view that the current regulatory framework, with its reliance on internal models, should be highly risk-sensitive and therefore most likely to promote better risk measurement and management in the longer term.

The underlying principle is that improvements in risk management are best achieved by promoting regulatory approaches that are aligned with internal bank risk management practices.

However, those who support this view still recognise that changes need to be made.

There need to be more restrictions on modelling assumptions and techniques, and an acceptance that not all risks can be modelled.

Moreover, safeguards can be put in place, such as capital floors and the leverage ratio, to serve as a backstop to the risk-based regime.

In summary, one side of the debate believes that the outcomes we want to achieve are best promoted by maintaining internal risk models, though in in a more limited way with floors and other safeguards.

On the other side of the debate, there is evidence that in some cases internal models have been used to minimise risk-weighted assets - and, therefore, regulatory capital - rather than to promote improvements in risk measurement and management.

Those who hold this view argue that the complexity and opacity of internal modelling approaches have hindered rather than helped supervision.

Moreover, they assert that the outcomes we want to achieve (including better risk management) can be promoted by significantly simplifying the regulatory framework.

It is important to note that, even under this approach, there is a role in the regulatory framework for the internal models of large internationally active banks.

For example, such banks could still be required to meet rigorous risk measurement and management standards but, instead of rewarding them with a lower capital requirement, a higher capital requirement would apply where banks fail to meet supervisory expectations for risk measurement and management.

I have laid out two quite different views of how the regulatory framework should be designed to best achieve our desired outcomes.

The one dangles a carrot to induce better risk measurement and management at banks and relies on internal models to determine regulatory capital requirements.

The other relies on supervisory-determined models for setting minimum capital requirements, but threatens a stick to penalise those banks that do not meet required risk management standards.

The questions I have posed, but which I do not intend to answer are:

- which regulatory framework is most likely to promote effective supervision, consistent implementation and effective risk measurement and management? and

- which approach is likely to find the right balance between simplicity, comparability and risk sensitivity?

The simpler we make the framework, the less risk-sensitive it becomes. Conversely, the more risk-sensitive the framework is, the more complex implementation and supervision become.

There are no easy answers, but the need to balance these items is becoming ingrained in the mindset of those responsible for policy development and implementation.

The Committee is undertaking a long-term strategic review of the capital framework to determine whether there are areas where we could reduce the level of complexity or where comparability could be improved to better meet the Committee's objectives.

We are also looking at whether the use of banks' own risk models to calculate regulatory capital is helping or hindering the Committee's pursuit of those goals.

Concluding remarks

To conclude, I would like to come back to my starting point - that is, the importance of communication and cooperation amongst supervisors.

The foundations of global banking are much stronger when we share information and act together in implementing sound prudential standards.

Cooperation and coordination enhance trust between authorities and improve our effectiveness.

Yet, as with any relationship, trust can take a long time to develop, but can be destroyed quickly.

The ICBS offers us all an opportunity to further build that trust.

For any financial system to function well, its players need to have confidence in each other - banks, regulatory authorities and market participants alike.

Market participants need to be able to compare reported regulatory ratios, and comparability needs to be supported by consistent implementation and a comprehensive disclosure framework.

And there needs to be confidence that the rules work: that riskier banks hold more capital and that the rules are consistently applied.

At the same time, we must continue to monitor implementation of the Basel reforms.

The Basel Committee has already started to assess the consistency of domestic implementation of Basel III capital requirements and will soon be broadening its review to include the LCR, systemically important bank frameworks and the leverage ratio.

Consistent implementation will help improve comparability, and reassure market participants that they can accurately assess bank risk.

As our work is ongoing, it would be wholly misleading to say that we are done.

A supervisor's job is never done.

We believe that we are on the right path to a more resilient financial system but we must remain vigilant in the face of changing banking activities and markets, and we must also learn the lessons from implementation.

The Committee is exercising this vigilance through its impact monitoring, by assessing the consistency of implementation, by refining selected elements of the framework, and also by thinking more broadly about the regulatory framework while staying alert to new threats to financial stability.

I hope that the discussions today and tomorrow are productive ones and that you find them valuable in steering your own work.

I also look forward to hearing your views on the issues on the Committee's agenda and wish you an enjoyable and rewarding two days in Tianjin.

Are we there yet? The United States and Canada after the global financial crisis

Remarks by Mr Timothy Lane, Deputy Governor of the Bank of Canada, at Carleton University, Ottawa, Ontario

Introduction

It is a pleasure to be here at Carleton University.
It has been a long time since I was a student here, but I still get caught up in the back-to- school feeling of September. It's a time of fresh starts and renewed energy.

Today I would like to talk about the economies of the United States and Canada and how our economic ties are evolving as the recovery from the financial crisis of 2008–09 continues.

I will discuss the impact on Canada of the Federal Reserve's unconventional monetary policies, and how Canada will be affected as these policies are gradually brought back to normal.

While there are risks associated with this process, the Bank of Canada sees it as a positive sign that the U.S. economy is experiencing its own fresh start and gaining renewed energy.

Ties that bind ... sort of

Let me start with the ties between the United States and Canada.

We are more than neighbours; perhaps we are more like fourth-year roommates.

Economically, we need each other and have strong links.

Over the years, we've been through good times and bad.
We live comfortably together, provided that we respect each other's space.

On the whole, having our fortunes linked with those of the United States works in Canada's favour.

Our businesses can take advantage of the opportunities of a much larger market.

That means more jobs in Canada.

But, over the past several years, we have also been reminded that these strong ties expose us to adverse forces in times of stress.

The old cliché is that "when the U.S. sneezes, Canada catches a cold."

There is an element of truth to that adage, but it only goes so far.

Our economies do not move perfectly in sync, partly because they are structurally different: most obviously, ours is much more reliant on natural resources.

And despite the strong influence of the United States, as economic policy-makers in Canada, we have plenty of scope to follow a different path.

To explore these ties – particularly as they relate to my own field, monetary policy – let's take a closer look at the financial crisis of 2008–09, the subsequent worldwide recession and the bumpy recovery.

First, I'll talk briefly about how Canada's experience through that period has been similar to, yet different from, that of the United States.

Then I'll elaborate on where we are now, the challenges facing policy-makers in the United States, and what they mean for Canada.

Tales of a global recession

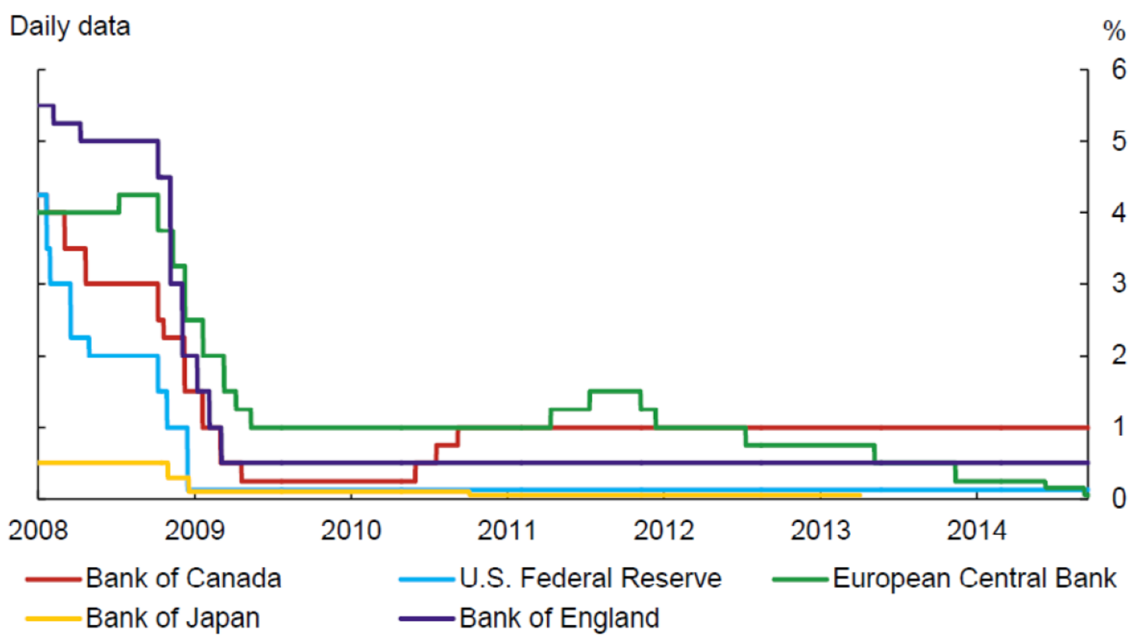
The financial crisis, which started with an overheated and precariously financed U.S. housing market, did not just affect Canada – it triggered a worldwide recession.

In 2008, the dramatic failure of Lehman Brothers was effective, if nothing else, in concentrating minds: the world looked into the abyss and took notice.

In a historic display of consensus, the G-7 agreed to take whatever steps were required to stem the crisis.

They lowered policy interest rates sharply (Chart 1) and in a coordinated manner; they flooded the financial system with liquidity to quell the panic; and they stood behind systemically important financial institutions.

Chart 1: Target interest rates were lowered sharply



Sources: Bank of Canada, U.S. Federal Reserve, Bank of England, European Central Bank, Bank of Japan, and Bank of Canada calculations

Last observation: 18 September 2014

These aggressive and coordinated policy actions prevented a financial and economic collapse that could have rivalled the Great Depression.

Nonetheless, they did not prevent a severe and protracted global recession, which led to a period of weak and uneven global growth that continues to the present day.

Through the crisis and beyond, the Federal Reserve acted aggressively and unconventionally – first to stem the crisis and, later on, to support the recovery.

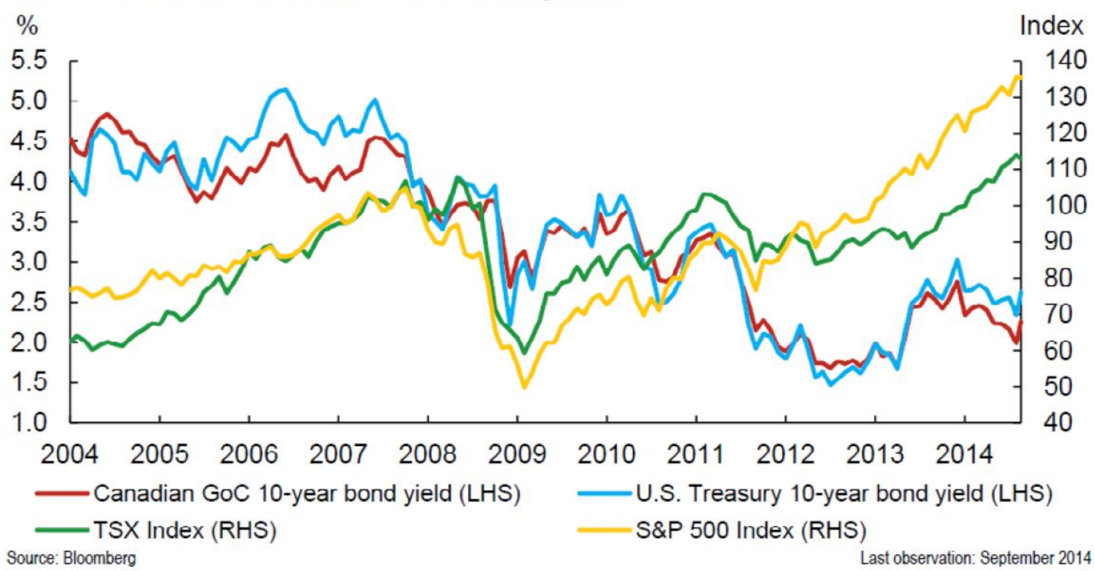
Like other central banks, the Fed began by boldly lowering its standard monetary policy instrument, the federal funds rate, as low as it could go.

With policy interest rates at their lower bound, the Federal Reserve also went to unusual lengths in providing forward guidance – communicating how long those rates would be likely to stay at their current level and, more recently, the factors that they would take into account in deciding when to start raising them.

The Fed also innovated by introducing large-scale asset purchases (LSAPs), best known as quantitative easing, or QE.

Chart 2: Falling bond yields and rising equity prices

TSX and S&P 500 - Index 2007 = 100, monthly data



QE provides an injection of liquidity into a stalled economy through the central bank's purchases of financial assets such as government bonds and mortgage-backed securities.

These operations have had pervasive effects on financial markets – not only in the United States but globally.

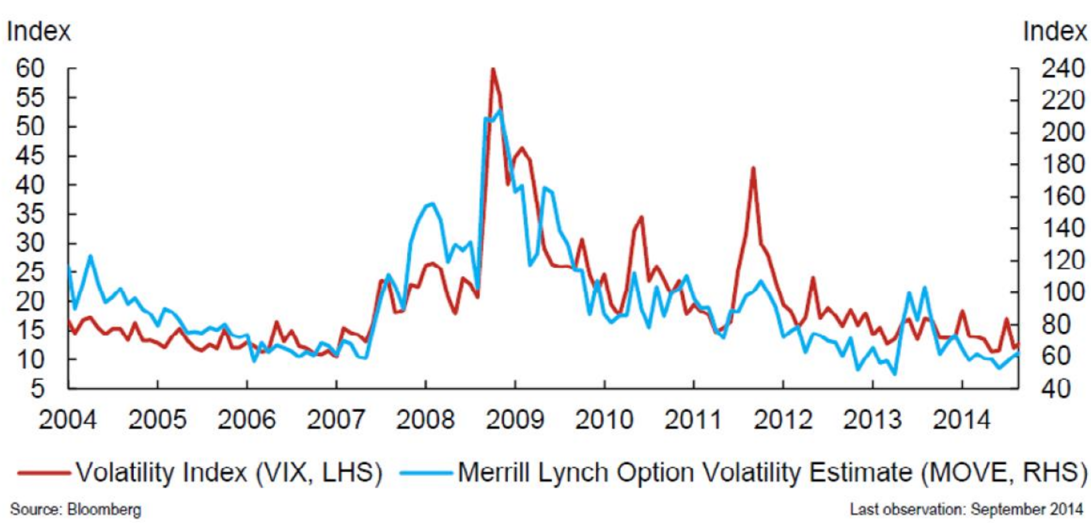
They work through a variety of channels, including by pushing down long-term interest rates and the external value of the U.S. dollar and pushing up the prices of risky financial assets such as equities (Chart 2).

As a related effect, these operations by the Federal Reserve – together with the unconventional policies of central banks of other major economies – have pushed the volatility of financial assets down to near historically low levels (Chart 3).

The resulting exceptionally buoyant financial conditions suggest that risk and vulnerability have increased in the financial system.

But, during this period, returning the United States to sustained economic growth has been of paramount importance.

Chart 3: Financial market volatility measures near historic lows



While there was some concern that QE could have resulted in runaway inflation, that hasn't happened.
In fact, the U.S. economy remained weak and inflation mainly below the Federal Reserve's target.

That's because QE was being carried out in the context of the widespread private sector deleveraging after the financial crisis; and, despite the unprecedented scale of the operations, it was still not enough to break the economy out of its post-crisis funk.

Canada: innocent bystander?

Here in Canada, we didn't have a homegrown financial crash.

While the Bank of Canada acted promptly and aggressively to provide liquidity to keep financial markets functioning, no banks had to be rescued and house prices didn't plunge.

This is not to say we were lily pure.

In fact, in 2007, a specialized Canadian market collapsed – the market for non-bank- sponsored asset-backed commercial paper (ABCP).

It was only through timely and forceful action by the public and private sectors that this situation was resolved without generating wider fallout.

Nevertheless, the recession in Canada was painful.

This was mainly because our exports collapsed. It's not just that about three-quarters of our exports go to the United States, but also that they are linked to sectors of the U.S. economy, such as housing and business investment, that fared particularly badly in the recession.

To get us through this period of very weak exports, we also relied on stimulative monetary policy.

Like the United States and other advanced economies, we lowered rates to their "effective lower bound" – in our case, 1/4 per cent.

Unlike the United States, we did not need QE, although we did provide forward guidance for our policy rate, itself a form of unconventional monetary policy, for the year following April 2009.

Our financial system was more robust, so easy monetary policy was transmitted into expanding credit for Canadian households and companies.

In contrast with the United States, we had a buoyant, albeit uneven, housing market through the recession and beyond.

Another important factor is that natural resource prices remained at elevated levels, so our resource industries recovered quickly.

These prices were supported by the strong growth in China and other emerging-market economies, which slowed down with the global recession but quickly picked up again.

The resource economy powered ahead, boosting disposable incomes, employment, engineering investment and government revenues.

Canada bounced back quickly.

By late 2010, we had passed the pre-crisis peak in GDP and employment – we were out of the recovery and into the expansion.

At the Bank of Canada, we saw a need to get interest rates off the floor and raised them in a series of steps to 1 per cent.
But then we were in for a round of disappointments and challenges of our own.

As Canada's recovery unfolded, our economy became increasingly unbalanced.

Our non-energy exports, after picking up quickly, stalled well below their pre-recession level (Chart 4).

Chart 4: Canadian non-energy exports stalled

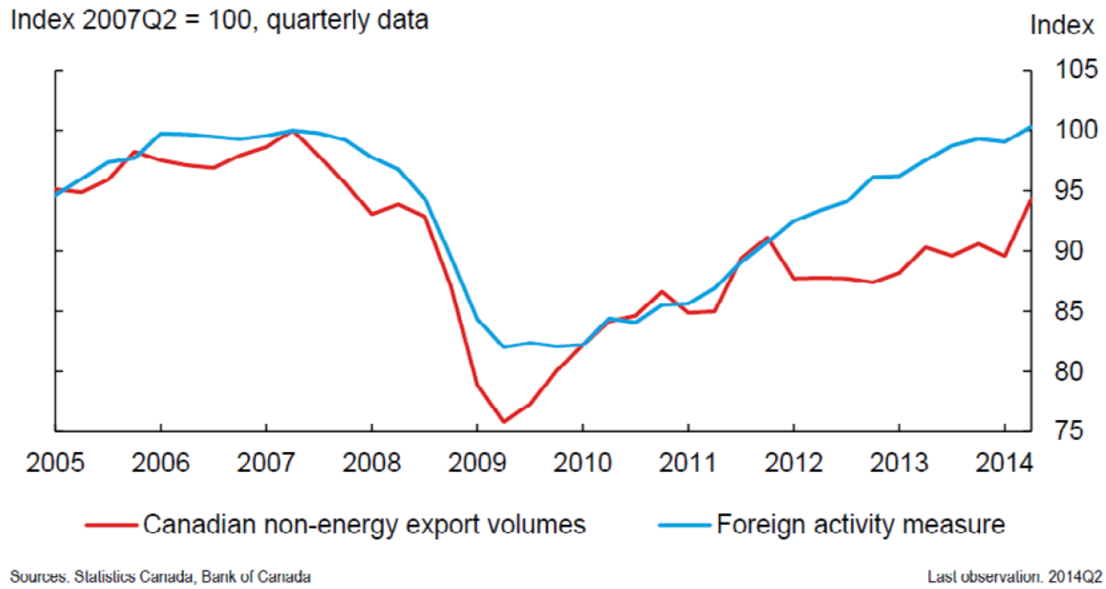
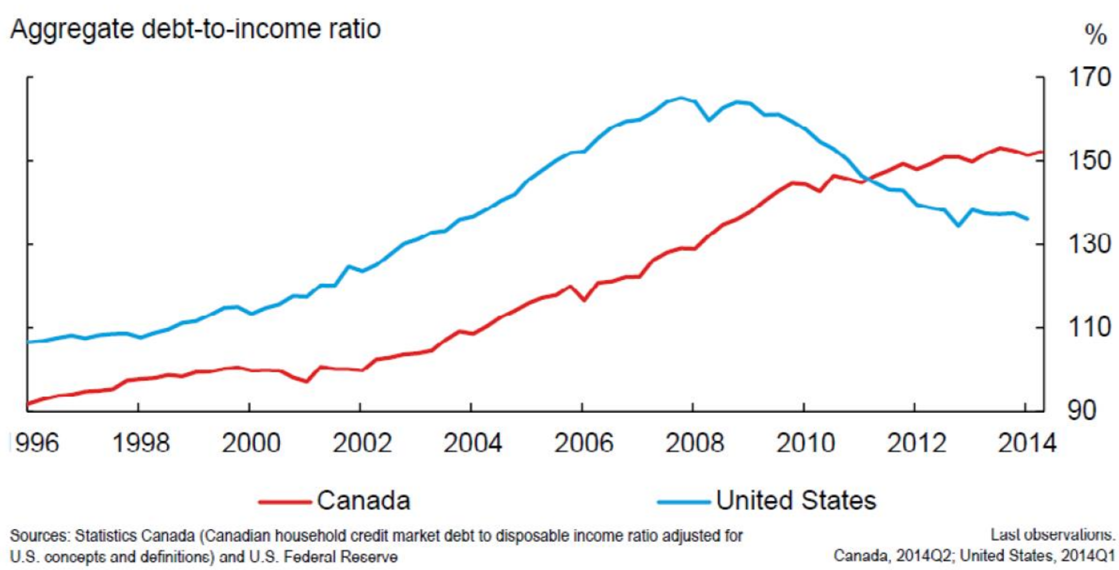


Chart 5: Canadians now more indebted than Americans



Economic growth became increasingly reliant on building more and more homes, mortgaged at rock- bottom interest rates and driving up the indebtedness of Canadians to unprecedented levels (Chart 5).

That source of growth was increasingly tapped out.

And it built up vulnerabilities in our financial system, which could spell trouble down the road.

Another disappointment was that, last year, even as the U.S. economy began to strengthen, Canadian non-energy exports did not pick up as expected.

Why not?

This is a puzzle we are much closer to understanding – but our understanding is still imperfect.

I won't dwell on this topic, as my colleagues have already said a lot about our weak export sector.

Suffice to say that weak exports have meant that Canada has had to rely on exceptional monetary policy stimulus for even longer than we expected.

Our policy interest rate has stayed at 1 per cent since 2010.

What effects did the Federal Reserve's unconventional monetary policies have on Canada during this period?

Our analysis indicates that, for Canada, their net effect has been positive.

The Fed's policies have pushed down our market interest rates and, by promoting U.S. growth, have added to the demand for our exports.

On the downside, these policies may have been one of the factors putting upward pressure on the Canadian dollar. But, on balance, the effects have been positive for Canada.

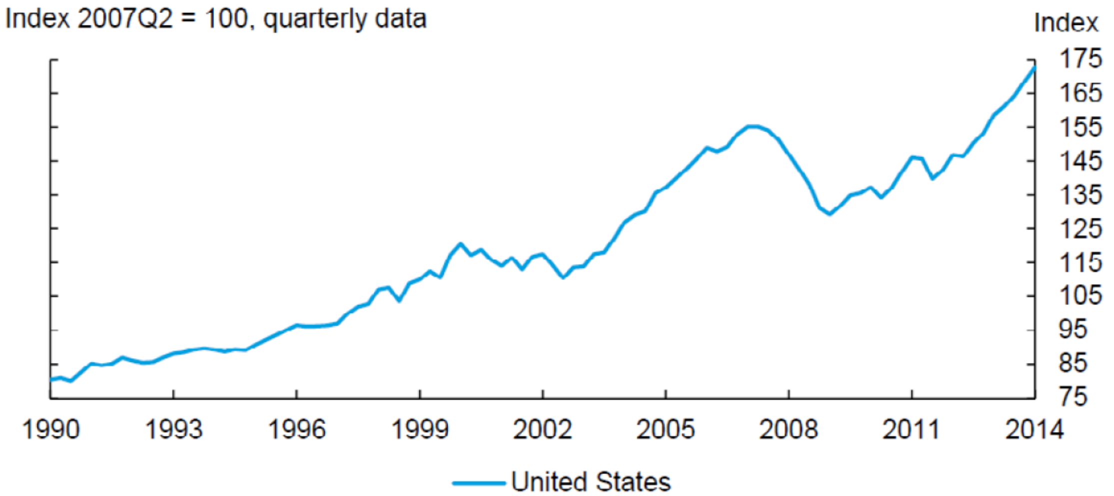
Morning in America?

So where are we now, in this long process of getting back to sustained economic growth? The U.S. economy is in expansion, with the private sector taking the lead.

The headwinds that came from deleveraging – consumers whittling away at heavy debt loads – are abating and the net worth of those consumers has improved markedly (Chart 6).

And the process of fiscal consolidation – bringing the federal budget deficit down to a more sustainable level – is largely complete (Chart 7).

Chart 6: Household net-worth to GDP ratio in the U.S. has risen markedly

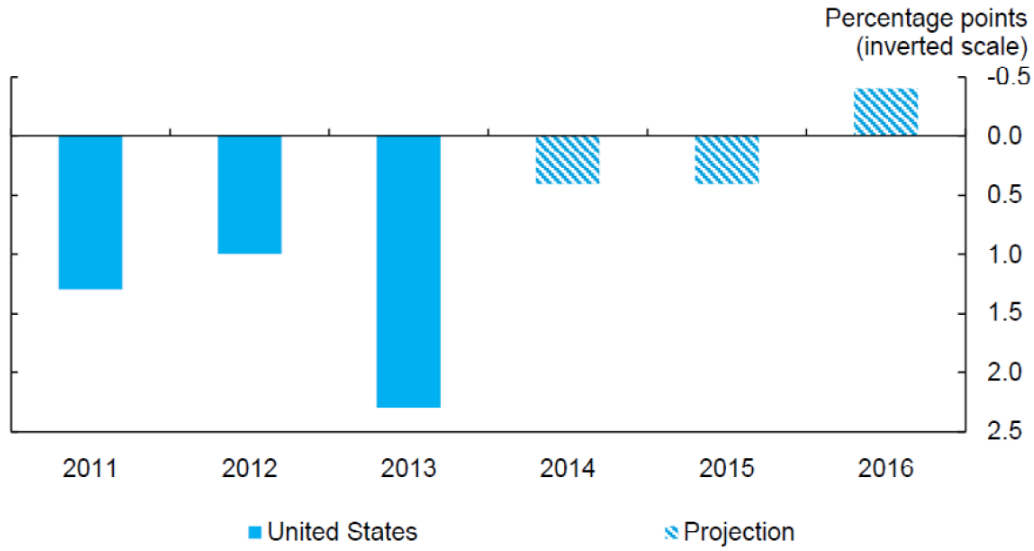


Sources: U.S. Bureau of Economic Analysis, U.S. Federal Reserve and Bank of Canada calculations

Last observation: 2014Q2

Chart 7: Current U.S. policies suggest significantly less fiscal drag over the projection horizon

Change in cyclically adjusted budget balance (as a share of potential GDP)



Source: International Monetary Fund, *World Economic Outlook* (April 2014)

But growth has remained fairly modest.

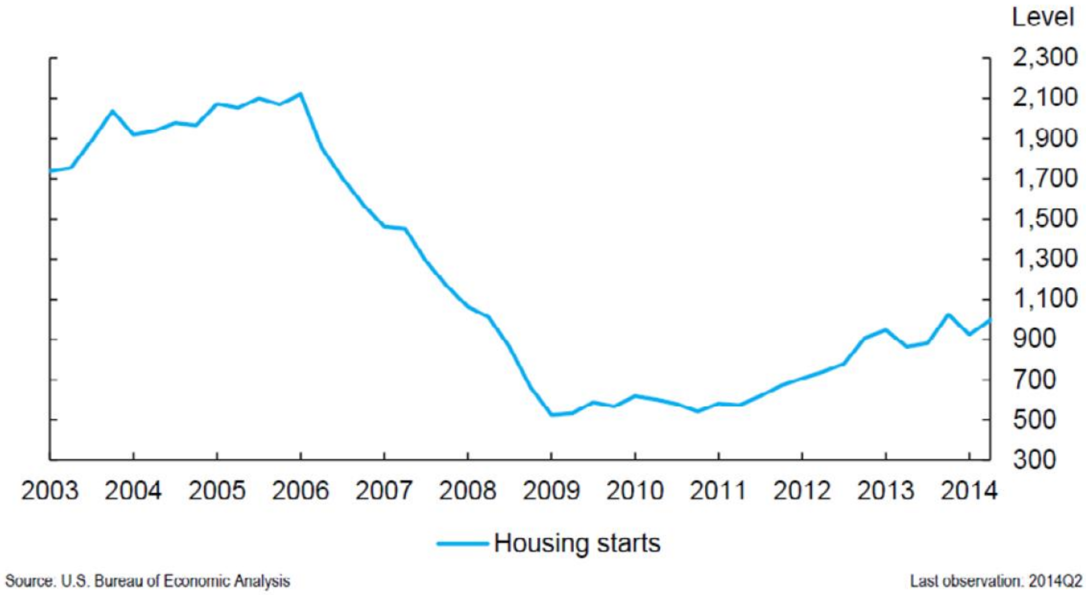
It's not quite clear why. Perhaps uncertainty about demand is still holding back business decisions and investment.

Given the rocky road of the last few years, this is to be expected.

While U.S. housing markets are reviving, they are following an uneven and uncertain path, and there is a lot of room for improvement.

Home construction is well below its pre-recession level, and the excess housing stock has largely been depleted (Chart 8).

Chart 8: U.S. housing market is taking a while to revive



Likewise, there is room for improvement in labour markets, which are a long way from normal.

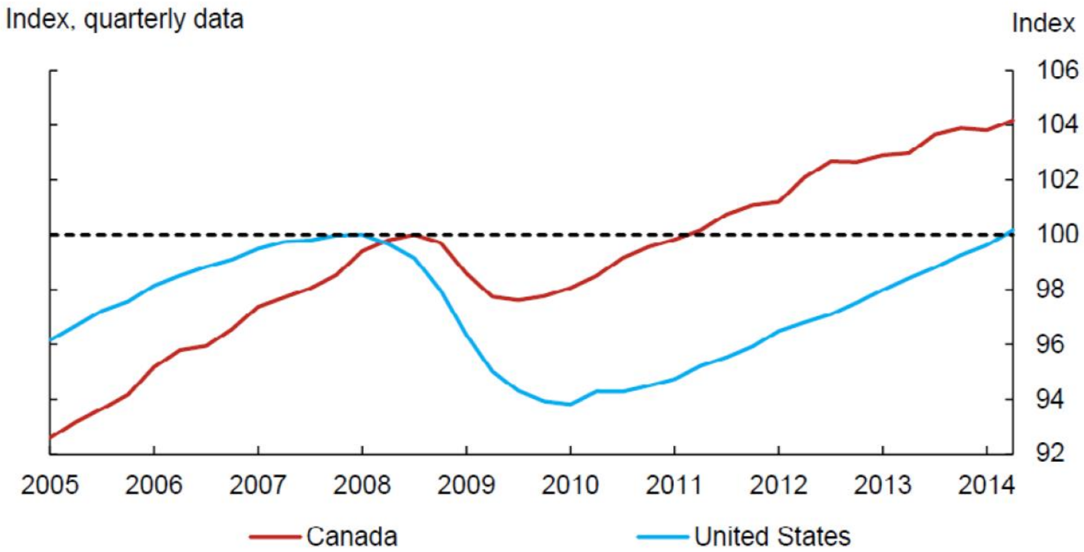
On average, about 200,000 net new jobs were created each month during the past three years. Unemployment, which spiked during the recession, has fallen by about 4 percentage points since its peak.

How does Canada compare?

Since Canada experienced a shorter recession, our labour market conditions did not deteriorate as much, and were also faster to recover.

For instance, by January 2011, Canada had recovered the number of jobs it lost during the recession – whereas the United States only reached that point in May of this year (Chart 9).

Chart 9: Employment in the U.S. only recently regained its previous peak



Note: Canada 2008Q3 = 100, United States 2008Q1 = 100
Sources: Establishment Survey, Statistics Canada; Establishment Survey, U.S. Bureau of Labor Statistics

Last observation: 2014Q2

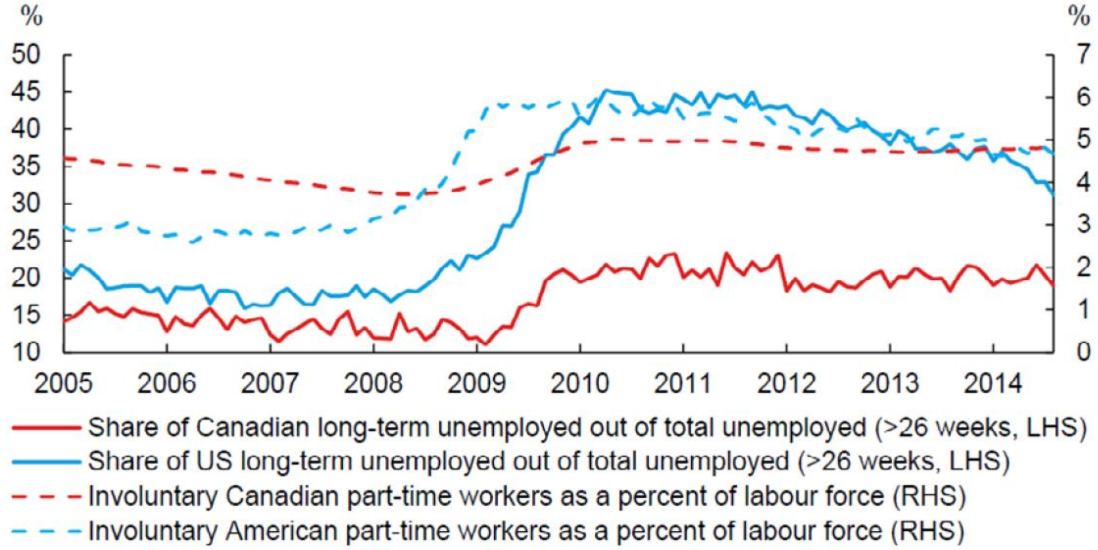
But since 2011, Canada has been creating new jobs at a much slower pace than has the United States.

Similarly, our unemployment rate did not rise as much during the recession, but has been coming down more slowly – and, if measured in the same way, is now at about the same level as it is in the United States.

In both countries, the unemployment rate does not fully capture the labour market slack.

In both the United States and Canada, there are still elevated levels of long-term unemployment and involuntary part-time employment, while wage gains continue to be moderate relative to historical norms (Chart 10).

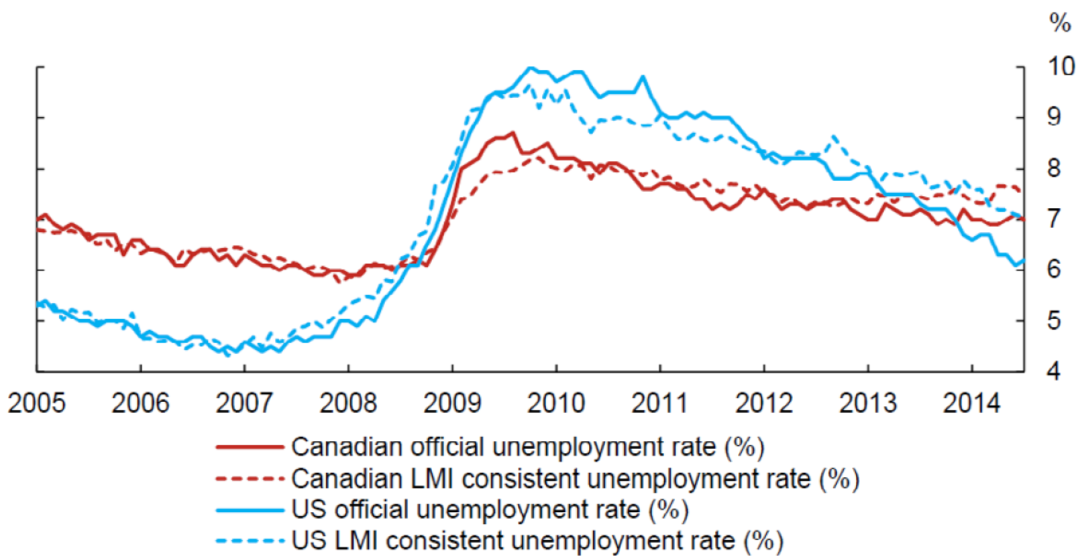
Chart 10: Shares of long-term unemployed and involuntary part-timers are elevated



Source: U.S. Bureau of Labor Statistics, Statistics Canada and Bank of Canada calculations

Last observation: August 2014

Chart 11: There's more labour market slack than the unemployment rate suggests in Canada and U.S.



Note: LMI = Labour market indicator

Sources: U.S. Bureau of Labor Statistics, Statistics Canada, Bank of Canada

Last observation: July 2014

And here, as in the United States, young people are having a hard time finding jobs, and many have dropped out of the workforce.

Our comprehensive measure of labour market slack has shown less slack than in the United States, but the gap has been narrowing (Chart 11).

In all, while the U.S. economy is improving, there have been bumps in the road, and there will be more as the expansion continues.

What is the Fed doing?

It is in this context that the Federal Reserve has been winding down its QE purchases and has signalled its plan to return gradually to a more normal monetary policy stance, starting sometime next year.

The precise timing and pace of that exit will depend on how the economy is performing.

Like most decisions, this involves a balancing of risks.

Tightening monetary policy too early could plunge the economy back into recession.

Moving too late could let inflation take off and require more tightening to get it back under control.

It could also result in bigger financial imbalances which, later on, if they unwind, could throw inflation into another downdraft.

A formal difference between the Federal Reserve and the Bank of Canada is the Fed's "dual mandate" to promote the goals of maximum employment and stable prices.

This is in contrast to the Bank of Canada's monetary policy framework: a target of 2 per cent inflation.

But this contrast between our inflation target and the Fed's dual mandate is not as sharp as it seems.

When inflation expectations are well anchored, bringing inflation sustainably to the target depends mainly on bringing the economy to its potential – in other words, closing the output gap.
In assessing the output gap, conditions in the labour market are one of the main things we look at.

Last week, the Fed reconfirmed that it will likely end its QE program at its next meeting in October.

This means that the Fed no longer expects to be purchasing additional financial assets under that program, which it has been gradually tapering since last January.

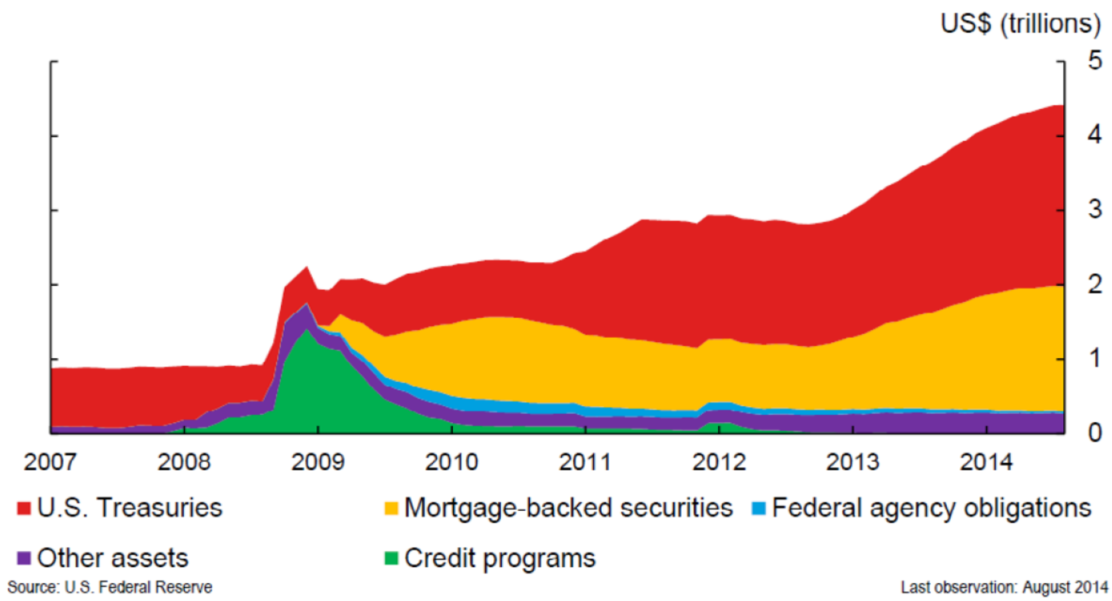
The next challenge for the Fed is how to unwind the various other elements of unconventional monetary policy stimulus, which include ultra-low interest rates, a large volume of excess reserves in the financial system and a large Federal Reserve balance sheet (Chart 12).

The composition of that balance sheet (e.g., government bonds of different maturities, mortgage-backed securities) may also matter.

When is it time to start to reverse these policies?

What are the right pace and sequence for each element?

Chart 12: Assets of the Federal Reserve System



A key step in normalizing policy will be to start increasing the target for the federal funds rate, which is currently still in a range of 0 to 1/4 per cent.

This can be accomplished, in part, by gradually raising the interest rate the Fed pays on excess reserves.

The Fed will also remove excess reserves from the financial system, in order to control short- term interest rates.

They have introduced and test-driven an overnight reverse repo facility that they will use for that purpose.

Restoring the Federal Reserve's balance sheet to its normal size is a process that is likely to be accomplished over a longer period.

It is important to note, however, that the size of its balance sheet will not hinder the Fed's ability to control the policy rate and liquidity in the economy.

The framework they have outlined will limit the risk that large excess reserves could lead to excessive loan creation and a sharp increase in inflation.

Does this sound complicated?

Yes – because it is complicated. But we have full confidence in our colleagues at the Federal Reserve to manage this process well.

How will the renormalization of monetary policy play out in the financial system – both in the United States and globally?

Asset prices, risk spreads and volatility are at levels that reflect the abundant liquidity provided through unconventional monetary policies in the United States and some other countries, together with expectations that interest rates will be kept at very low levels for a long time.

While the Federal Reserve will seek to guide the renormalization process so that markets readjust smoothly as monetary policy is brought back to normal, there is an important risk that there will be some bumps along the way.

What will the exit mean for Canada?

On the whole, the Federal Reserve's planned exit from unconventional monetary policies is part of a good news story for Canada. It is a sign that a sustained U.S. expansion is well under way.

A more sustained U.S. expansion – a stronger housing market and robust business investment – should help our non-energy exports, which remain below their pre- recession level.

As the U.S. economy regains vigour, it should also contribute to improved business and consumer confidence in Canada.

However, from a policy-maker's perspective, the renormalization of U.S. monetary policy will act to tighten Canadian monetary and financial conditions.

The same analysis indicating that QE had stimulative effects on Canada should also work in reverse: unwinding unconventional policies will tend to push up market interest rates in Canada and dampen the U.S. expansion.

This effect would only be partly offset by the downward pressure the exit would put on the value of the Canadian dollar.

In the event that the Fed's renormalization does not play out smoothly in financial markets, the impact on Canada could be significant.

So how will all of this influence what the Bank of Canada would do?

You can probably already anticipate my answer: "It depends."

The Bank of Canada's goal is to achieve our 2 per cent target for inflation in a sustainable way, which requires that our economy run close to its full potential.

We will need to assess the various countervailing effects in the context of Canadian economic and financial conditions more generally.

Like the Fed, we will balance the risks of acting too soon and stifling burgeoning economic growth against the risks of acting too late and letting inflation overshoot and fuelling imbalances in our housing markets.

But that balance of risks is likely to be different here than in the United States.

Thus, while monetary policy in the United States has an important impact in Canada, I want to stress that Canadian monetary policy is independent and can diverge from the Fed's policies.

In fact, our policy rate is already higher than the Fed's as a result of the moves we made four years ago in response to the improving economic conditions at that time.

Looking forward, as always, our rate decisions will depend on the state of the Canadian economy. Preserving the value of money by keeping inflation low, stable and predictable is our mandate.

Are we there yet?

Let me conclude. The financial crisis of 2008–09 reminded us how tightly linked the U.S. and Canadian economies are – for better or for worse.

And the economic recovery has shown us that healing after a financial crisis is slow and often painful.

The steps taken by the U.S. Federal Reserve, the central bank closest to the epicentre of the crisis, prevented the crisis and subsequent recession from being much worse.

And they continue to support the U.S. and global economies through that long healing process.

The Fed's unconventional monetary policies affected Canada through various channels, notably by pushing down market interest rates worldwide.

By the same token, as Fed policy returns to normal – which is likely to be a different state than before the crisis – that will tighten financial conditions in Canada.

But this will be happening against the backdrop of stronger economic growth.

It's another step away from the dark days of the Great Recession and an affirmation that the hard work of economic reconstruction over the last six years is taking hold.

Putting the right ideas into practice

Speech given by Mark Carney, Governor of the Bank of England at the Institute and Faculty of Actuaries General Insurance Conference, Wales

Introduction

It is an honour to be invited to address you today. Insurance is at the core of the new Bank of England.

As regulator, we are tasked with ensuring the safety and soundness of the UK's insurance companies and the protection of their policyholders.

To discharge these responsibilities, we draw on the entire resources of the Bank.

Fully one third of our regulatory staff – over 200 supervisors and 50 actuaries – are engaged in supervising insurance companies.

But that is just the start.

Our supervisors are supported by hundreds of credit risk analysts, scores of monetary policy experts and macro-financial analysts.

As a central bank with responsibilities for both monetary and financial stability, we have a view of both the asset and liability sides of your balance sheets.

And as a highly active participant in global financial reform, we influence the measures that are reshaping the global system.

In all of our actions, we recognise the importance of insurance to the economy.

The UK insurance industry makes a major, direct contribution: £25bn to annual GDP and 300,000 high-paying jobs including many of the 14,000 members of the Institute & Faculty of Actuaries.

It is a major exporter with about 30% of premiums earned overseas.

And the Lloyd's market underlines London's status as a world centre for insurance excellence and innovation.

But the economic contribution of insurance goes much deeper.

By spreading and managing risks, it increases the resilience of corporations, investors and financial institutions.

It makes entrepreneurship and trade more viable.

And it safeguards companies and individuals from perils they could not otherwise shoulder.

From a financial system perspective, insurance companies play a vital role in the efficient allocation of capital.

By matching long-term savings and investment, it finances the infrastructure essential to build our economy.

The long-term perspective of insurance companies diversifies the financial system and reinforces its resilience.

The contribution of the UK insurance industry can't be taken for granted – especially in a macro-financial environment that challenges traditional business models.

Challenges from the macro-financial environment

Of course, relative to the recent past, the economic outlook is much improved.

The UK has experienced the strongest growth in the G7 over the past year.

Job creation has been the quickest on record. Inflation has fallen below target having been above for most of the past five years.

With many of the conditions for the economy to normalise now met, the point at which interest rates also begin to normalise is getting closer.

In recent months the judgement about precisely when to raise Bank Rate has become more balanced.

While there is always uncertainty about the future, you can expect interest rates to begin to increase.

We have no pre-set course, however; the timing will depend on the data.

Moreover, the precise timing of the first rate rise is less important than our expectation that, when rates do begin to rise, those increases are likely to be gradual and limited.

Why does the Bank expect this to be the case?

In part, because the headwinds facing the economy are likely to take some time to die down. Demand in our major export markets remains muted.

Public balance sheet repair is ongoing.

And a highly indebted private sector is likely to be particularly sensitive to changes in interest rates.

Over the medium term, several dynamics are likely to keep rates lower than in the past.

UK rates could be restrained by continued imbalances between global saving and investment, together with potentially lower rates of global productivity growth.

Central banks can also be expected to accommodate with lower risk-free rates the higher spreads that are likely to result from new regulatory requirements.

All of these factors likely mean that, even when spare capacity is used up, Bank Rate will need to be materially lower than in the past in order to keep the economy operating at its potential and inflation at its target.

The Bank is well aware that a prolonged period of historically low interest rates could encourage other risks to develop.

In the UK, the biggest risks are associated with the housing market, which is why last spring the Bank took graduated and proportionate actions.

We are also alert to the possibility that financial markets may be mispricing risk.

As the FSB concluded last week, "there are increased signs of complacency in financial markets, in part reflecting search for yield amidst exceptionally accommodative monetary policies.

Volatility has become compressed and asset valuations stretched across a growing number of markets, increasing the risk of a sharp reversal."

In such circumstances, insurers' proven ability to look through such short term volatility is invaluable.

Nevertheless, an abrupt correction in term and risk premia could have a sharp impact on the valuation of securities that are marked to market and reduce the effectiveness and availability of proximate hedging strategies.

More fundamentally, by squeezing margins, persistently low interest rates challenge business models.

Insurers feel this pressure on both sides of the balance sheet: through muted investment returns; and as long-term obligations to policyholders – most common for life firms but increasingly relevant to general insurers that have Periodic Payment Orders on their books - become more expensive in today's terms.

An understandable response would be to move towards less traditional types of investments – such as infrastructure; into new or more complex

types of business – like telematics pricing; or into new geographies like emerging markets.

All these strategies bring new risks that must be well understood and prudently managed

Low rates are encouraging inflows of external capital into sectors like reinsurance. In effect, a "soft cycle" in financial markets is reinforcing a "soft cycle" in insurance – a particularly problematic combination.

More capital boosts market capacity, but can also test underwriting discipline.

Putting the right ideas to work

As supervisor, the Bank of England is monitoring closely how these new risks are being managed and how your business models are evolving.

At the same time we'll be implementing reforms.

Reforms to promote a more resilient insurance sector without standing in the way of an effective insurance sector, and without imposing unnecessary impediments on your ability to evolve your business models in response to the challenges I described.

To borrow the theme of this conference we will be 'putting the right ideas to work'.

Today I want to highlight three of them:

- **Tailored, consistent and robust capital standards;**
- **Holding the right people to account; and**
- **Global standards for globally systemic insurers.**

With those right ideas, we are promoting a resilient, innovative insurance industry that supports the real economy.

Right idea 1: tailored, consistent and robust capital standards

The first right idea is to implement tailored and consistent capital standards to ensure the safety and soundness of insurers.

Resilience against unexpected losses requires risk-based capital standards and robust valuation practices.

The UK's Individual Capital Adequacy Standards deliver this and were one reason why the UK's insurance sector weathered the crisis so well.

The Bank of England wants the principles behind ICAS to be applied as widely as possible; to establish as level a playing field as possible.

That is why we support Solvency II. It embeds across Europe the core principles necessary for sound regulation, namely:

- **appropriate market-based valuation methodologies;**

- **a comprehensive measure of risk and solvency covering all group activities; and**

- **capital resources of an appropriate quality to absorb loss.**

Solvency II is the biggest change to insurance regulation in a generation, and it will be live in just over a year.

While our shared history with ICAS means the UK insurance industry is relatively well placed, we must not underestimate the scale of the challenge.

Even the standard formula, which nine out of ten UK insurers will use to determine their solvency requirements, is significantly more advanced than the Solvency I approach it replaces.

Although more demanding, we have worked to ensure the standard formula does not impede your provision of long-term finance to the real economy.

Steps have been taken to make Solvency II more accommodative of securitisation.

And in parallel, the Bank of England has been working with the European Central Bank to remove other impediments to the revitalisation of securitisation markets, including pushing for revisions to regulatory requirements for banks and for the development of simple, transparent and consistent products.

Where the standard formula is not a good fit for a firm's risk profile, firms will be asked to consider developing a partial internal model; making an application for an undertaking-specific parameter; or adjusting their underlying business model.

Many of you in this room are acutely aware of the demands of the Solvency II model approval process.

This rigour has a purpose.

The dangers of using poorly designed models were made all too clear in the banking sector.

So the Bank won't hesitate to withhold approval of inadequate or opaque models.

Models must be based on appropriate data and account for all quantifiable risks.

Boards have the responsibility to ensure models remain appropriate and to show they are used in practice.

Of course, risk-based capital standards are about more than models. Models can never be relied upon in all circumstances or in isolation, nor can they be substitutes for sound judgment.

Solvency II recognises this in its three-pillar approach – supplementing a modernisation of the quantitative regime with new supervisory review, governance, risk management and transparency requirements.

These requirements, under pillars 2 and 3, build a coherent framework for the future.

Tools like scenario testing and the Own Risk Solvency Assessment are therefore fundamentally important.

By thinking about the risks that could harm future solvency – and the possible responses to a stress – ORSAs promote the protection of safety and soundness of insurance firms, while providing insights into overall financial stability.

Right idea 2: a regime that holds the right people to account

The step-change in regulatory standards under Solvency II has several implications for the industry.

Risk professionals like yourselves have a central role to play in building models; in using expert judgment to marry quantitative and qualitative assessments of risk; and in making technical subject matter accessible to Boards.

Your work will be vital to making these new standards a reality and thereby to establishing a stronger, more consistent standard of resilience across the EU.

But amidst our work to embed new regulatory standards, it must not be forgotten that the responsibility for running insurers rests with their Boards and senior managers.

This leads to the second right idea we are putting into practice: the people running insurance companies should be more clearly held accountable for their actions.

It is now clear that in some parts of the financial sector, the link between seniority and accountability had become blurred or even severed.

The Parliamentary Commission on Banking Standards recognised this when they recommended a new regime for the senior-most managers in banks, ensuring their accountability.

The principles underlying that regime are more widely relevant.

Those individuals that run financial institutions should act with integrity, honesty and skill regardless of whether they work for global investment banks, regional building societies or in the general insurance sector.

Solvency II recognises this imperative.

It requires both firms and regulators to monitor the fitness and propriety of staff with key responsibilities in the insurance sector

As a consequence, the Bank of England is now working with other regulators to develop a regime for the key people in your industry.

That doesn't mean we are about to extend the banking regime indiscriminately.

For one thing, unlike in banking, there will be no statutory provision for applying a "reverse burden of proof" in the insurance sector.

In developing a regime tailored to insurance we will also have to consider the particular skills and roles that matter.

This includes the central role of actuaries, which is one of the important functions specifically recognised by Solvency II.

In 18th century London, the title 'actuary' was often interchangeable with that of Chief Executive.

It's your role in backing entrepreneurship with science; in ensuring premiums, reserves and capital are prudent; and in scanning the horizon for new risks and opportunities, that means we are minded to include both life and general insurance actuaries within the scope of our updated fit and proper regime for individuals in insurance.

By including your profession in the new regime, we recognise the importance of your skills, the range of your contributions, and your personal propriety.

Later this year we will consult on a regime that includes the most senior actuaries – alongside CEOs, Chairmen and Chief Financial and Risk Officers – in our senior managers regime, making them directly accountable for how a firm is run, for their decisions, and for their actions.

These senior persons will be expected to prove their fitness to regulators before they take up a role, and the onus will be on them to ensure risks are understood, measured and properly considered.

Right idea 3: global standards for globally systemic insurers

While much progress has been made on the home front, the focus of the global reform agenda since the crisis has been on putting a third idea into practice: common global standards for systemically important insurers.

The goal of this work is to increase systemic resilience; preventing spillovers from the failure of an insurer to the wider financial sector and the real economy.

Policymakers agree that traditional insurance activities need not of themselves be a source of systemic risk.

Indeed, recent events demonstrated three reasons why insurers are better able to withstand crises than other financial institutions.

First, the underwriting cycle is generally not correlated with the business cycle;

Second, the inherent resilience of business models that take a long-term view, and

Third, an insurer's production cycle is inverted as they collect premiums today with a view to paying claims tomorrow.

This model reduces liquidity risks and immunises insurers against risks of a run.

Insolvency takes time to manifest, and wind-down when it happens has historically been more orderly.

Given all that, you might ask: why the concern about systemic risk in insurance?

The answer is simple: The financial crisis laid bare that the actions of some individual insurers – like AIG – can have broad spillovers; that some insurance markets – like the monolines – are systemic, and that the insurance sector plays a systemic role in diversifying the financial sector thereby reinforcing its resilience.

AIG was the extreme case of a systemic insurer.

That sorry experience highlights the need to understand all the activities in which insurers are engaged, including on occasion substantial business beyond the boundaries of traditional insurance.

Regulators have grouped those activities as 'non-traditional' and 'non-insurance' – including business involving extensive use of market instruments, like derivatives, and instruments that engage in substantial maturity transformation.

Where this type of business is carried out in scale or across borders, risks to the system can be substantial.

The crisis also showed how particular insurance markets can affect systemic stability.

The Monolines demonstrated how sub-sectors that are excessively concentrated or undercapitalised can amplify shocks.

The failure of multiple insurance companies in response to economic stress can disrupt the provision of critical economic functions.

It can also suddenly transfer risks to other parts of the financial system that may be ill-equipped to manage them; or shift assets around in a way that can amplify and spread distress.

As I said previously, the insurance sector is systemic in a positive way. Insurance companies have different risk bearing capacities than many other financial institutions.

They play a stabilising role by deploying funds over a longer time horizons, in a manner less vulnerable to sudden outflows.

The resilience of large insurers is therefore important to safeguard that positive contribution to the global economy.

The starting point for the application of global standards has been the identification of systemically-important insurers.

More than four-fifths of that assessment rests on the extent of non-traditional non-insurance activities in a firm's business model and on its interconnectedness to the wider financial system.

Nine firms have been designated.

It is vital that these systemic insurers, like systemic banks or financial market infrastructure, can be resolved in the event of failure without the need for taxpayer support and without disruption of the wider financial system.

That's why the development of resolution plans is a top priority.

Nonetheless, given the externalities from the failure of a systemic insurer, it is of course preferable that their probability of failure is lower.

That's why systemic insurers will be subject to higher global standards.

The Higher Loss Absorbency requirements, being developed now by the IAIS, will ensure that all of the activities of a systemic insurance group – but especially non-traditional, non-insurance activities – are backed with an appropriate minimum level of capital resources.

Given the patchwork of capital standards across major jurisdictions, the first step towards applying these heightened resilience requirements is the development of the Basic Capital Requirement – an internationally comparable capital measure that will act as the baseline for additional resilience.

Last week in Cairns, the FSB approved the final BCR proposal which will be presented to G20 Leaders at the Brisbane summit in November.

It is simple and factor-based, contains a common valuation approach, and captures all activities of insurance groups.

This is an important milestone – one that takes us further towards embedding the right idea of increased resilience for those few insurers that have the capacity to impact the global financial system.

I look forward to your continued support as the IAIS builds on this progress to put into practice the overall package of requirements for systemic insurers by 2019.

And we will need your support as we further develop, over time, an International Capital Standard to apply to all internationally active insurance groups.

Our aim is nothing less than a standard which embodies the principles which underpin ICAS and Solvency II.

Conclusion

The ideas I've described today are vital to preserving the positive role of insurance in the financial system and the real economy.

These ideas – tailored capital standards that promote a level playing field; a framework to hold the right people to account; and global standards for globally systemic insurers – are needed now in practice.

The Bank knows that as our reforms are implemented and as your business models evolve we need a regulatory approach that is regularly reviewed, adjusted if necessary; and that takes account of evolving financial conditions, product innovation and changing markets.

Robust interaction with the industry is essential to ensuring the right ideas can be put into action now, and for the future.

The Institute & Faculty of Actuaries has been at the heart of the insurance industry for over 150 years, and the changes to regulation, the industry and the world around us mean your contribution is more essential than ever.

Having the right people putting the right ideas to work has never been more important.

Restoring confidence in reference rates

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Salomon Center for the Study of Financial Institutions, New York University Stern School of Business, New York City

Thank you for the opportunity to speak with you today.

In my remarks today, I will focus on the development and use of reference rates for financial market contracts. This is a story of both spectacular success, and at the same time, spectacular failure.

To borrow from Charles Dickens:

"It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity.-"

While Dickens was writing about events leading up to a political crisis, his words also are apt with respect to our recent financial crisis.

Over a period of just a few decades, reference rates grew greatly in terms of their role and importance in financial markets.

For example, the use of one of the best known reference rates - the London Interbank Offered Rate, or LIBOR - has soared, so that it is now referenced by approximately $300 trillion dollars of financial contracts.

Reference rates have become a ubiquitous but largely hidden fiber in the fabric of financial markets.

They play a critical role in making financial markets more efficient by reducing information frictions, lowering transactions costs and mitigating the moral hazard.

At the same time, as recent enforcement actions and criminal investigations have made all too clear, some of these reference rates have been systematically manipulated by individuals at key financial institutions.

The assumption that the design in how these rates are constructed would be resistant to attempts at manipulation has turned out to be wrong, and the belief in the integrity of these rates has turned out to be misplaced.

What this means should be obvious to all of us.

Reform is required if we are to restore confidence in the financial system.

In my remarks today, I will discuss the outlines of such a reform including those important steps that are already underway, and those steps that still must be taken.

As always, my remarks reflect my own views and not necessarily those of the Federal Reserve System.

The most recognized and prevalent of the reference interest rates is the London Interbank Offered Rate, typically referred to as LIBOR, which measures the cost of unsecured, interbank borrowing across different currencies and tenors.

The development of LIBOR goes back to the rapid expansion of the Eurodollar market in London beginning in the 1970s.

This was a market that developed, in part, as a means of circumventing the Regulation Q deposit interest rate ceilings in the United States.

This market provided a source of funds for international banks, and securities that referenced Eurodollars were issued and became actively traded.

This growing market gave birth to a new financial market product - the interest rate swap - to help investors and borrowers to better manage the interest rate risks associated with their financial exposures.

In 1984, as part of the "Big Bang" in U.K. financial markets, the British Bankers Association (BBA) assumed responsibility for developing a set of standards for these interest rate swaps.

One of these standards was for the reference rates used to fix the settlement of the contracts - this led to the birth of LIBOR.

Additional standardization followed, including establishing a fixed schedule of settlement dates for these contracts.

This further increased the liquidity in these contracts, but also significantly concentrated the timing of settlement activity.

At the same time, new reference rates were developed that extended the LIBOR-style methodology to many different currencies.

How LIBOR was designed to work

LIBOR is a set of reference rates that measure large banks' funding costs in different currencies and at different maturities.

For example, U.S. dollar LIBOR measures how expensive it is for a large bank to borrow U.S. dollars in the unsecured interbank market at different maturities.

For each currency, there is a designated panel of contributing banks that each submit an estimate of its own borrowing costs for each maturity.

For each panel, these estimates are aggregated to form LIBOR.

The LIBOR rates are then used as a basis for financial contracts ranging from adjustable rate mortgages to interest rate swaps and futures.

To make sure that the submitting banks have sufficient expertise in the funding trends in a particular currency, it is important that they be actively involved in that market.

For this reason, the contributing banks are the large banks that have been active in the London market and the panel of submitting banks varies across currencies.

The LIBOR reference rates were intended to capture on a daily basis borrowing costs along each currency-maturity combination based on the experience of the submitting banks.

The actual process for fixing LIBOR each day is quite straightforward.

Each morning the submitters from each contributing bank answer the following hypothetical question: "At what rate could you borrow funds, were you to do so by asking for and then accepting interbank offers at a reasonable market size just prior to 11 a.m.?"

The transmitted submissions are ordered by rate for each currency and maturity pair.

The ordered rates for U.S. dollar LIBOR, for example, are then trimmed by generally dropping the top and bottom 25 percent of submissions to remove any influence of outliers.

The average of the remaining individual submissions is calculated and then posted.

Prior to the recent reforms, all submissions were immediately made public.

The aim of the LIBOR-setting process has been to create a set of reference rates that would be credible and would generate robust measures of bank funding costs across a wide range of market conditions.

The credibility was based on the borrowing experience from the submitting banks represented through their submitters - those individuals responsible for actually submitting an answer each day to the administrator.

The potential conflicts of interest between the submitters and traders within the bank were typically handled through internal policies such as the presence of information barriers that were intended to prevent sensitive information from flowing between the traders and LIBOR submitters.

The robustness to market conditions would be maintained even in periods of market stress or a lack of transactions by the reliance on the hypothetical question instead of the use of actual transaction data.

That is, even if during stressed times when trading became sporadic in a particular currency-maturity pair, all submitters could still answer the question even if their bank did not happen to engage in any trades on that particular day in that particular pairing.

This ensured a large sample size even during stressed market conditions.

The trimming of the sample helped to minimize the influence of any outlier submission, but also limited the ability for any one submitting bank to influence the posted rate.

As is clear from the hypothetical question, LIBOR is meant to capture a bank's cost of unsecured borrowing.

This means that the reference rate will reflect not only a risk-free component, but also counterparty credit risk related to the specific borrower.

This turns out to be important for two reasons.

First, the growing popularity and liquidity of LIBOR indexed contracts led to an expanded use of LIBOR to circumstances in which the credit risk of large banks was not clearly relevant.

For example, a speculative position about the future of short-term rates is predominately based on one's view about the path of short-term interest rates, rather than how bank counterparty risk might change and affect borrowing costs.

Despite this shortcoming, LIBOR remained popular because the benefit of its deeper market liquidity was viewed as more important than the

added complication that LIBOR included an element of counterparty risk.

Second, variations in LIBOR submissions across the submitting banks at a point in time for a given maturity should mainly reflect differences in the counterparty credit risk, since the risk-free component is common to all submitters.

This is important because it means that variations in submissions may be interpreted as reflecting variations in underlying counterparty risk.

This is particularly important when the LIBOR submissions process is transparent and the market is under stress, which was the case during the financial crisis.

How LIBOR worked in practice

Now that I have described how LIBOR was intended to work in concept, how did it work in practice?

It turns out that unappreciated design weaknesses and incentive structures at certain large submitting banks, in combination with the phenomenal success of reference rates, undermined the system.

Conflicts and problems emerged both at the bank level and at the individual submitter level.

Investigations are on-going to determine the scale and full extent of these problems, but I would like to discuss a few of the well-documented problems.

Let's start at the level of banks that submit estimates.

The enforcement actions and investigations into potential LIBOR manipulation have shown that, at times, individual institutions faced incentives to understate their hypothetical borrowing rates in order to avoid the perception that they might have higher counterparty credit risk.

Some of the reported misdeeds occurred during the heart of the financial crisis when market participants faced considerable uncertainty about the health of particular institutions.

This uncertainty was manifest in a wide range of financial market prices for financial institutions - low and volatile equity prices, record CDS spreads and greater variation in borrowing costs across different LIBOR-submitting banks.

At that time, the BBA was publishing firm-specific contributions to LIBOR from submitting banks.

Given this publication process, some of the submitting banks reportedly became concerned about reporting a rate that would suggest that they were being treated by the market as a greater counterparty credit risk than their peers.

Accordingly, some banks were alleged to have lowered their LIBOR submission below their actual likely borrowing rate to avoid the stigma associated with posting a higher borrowing rate and the possibility that their funding costs could increase as a result.

Conflicts also reportedly abounded at the level of the individual submitters.

Again, these highlighted profound compliance problems at some of the submitting banks.

As I noted earlier, the intent was that the expertise of the submitter would be insulated from any internal pressures by the informational barriers within the submitting banks.

The hope was that these informational barriers separating the submitters from the traders were thick and impenetrable.

The investigations into LIBOR manipulation found that the reality was that they were often paper thin and porous.

We have learned that false reporting and manipulative behavior was pervasive across firms and over time, took many forms and was often conducted in a nonchalant manner.

This has been well-documented by the Commodity Futures Trading Commission in their published findings.

For example, interest rate swap traders routinely asked colleagues to submit rates with an explicit goal to have the adjusted submission benefit the value of specific derivatives positions they held.

As an illustration, investigations discovered that one "Senior Yen Trader" directly or indirectly made at least 800 requests in writing on UBS's email and chat systems to their submitter.

Requests often had a casual matter of fact nature to them.

To illustrate, an exchange in September 2007 from a trader at UBS to the submitter went as follows.

"Hi - could really do with a low 1M [one month] over the next few days as have 17.5m [million] fixings if ok with you?"

Submitting banks often facilitated this type of behavior - in some cases derivatives traders and submitters sat on the same desk, while in others the submitters were themselves traders, both circumstances obviously representing conflicts of interest.

Other investigations documented that traders at one bank would often shout across the trading desk to fellow traders to confirm that there were no conflicting requests before they sent their requests to their submitter.

The investigations also found that not only were there conflicts within the submitting banks, but there were also active efforts by traders to collude across banks to affect the posted rates.

At times, the traders at the different banks might have similar positions and therefore a common interest to push the posted rate in particular direction.

In other times, cooperation could be incentivized through the use of "wash" trades that generated no profit or loss, but allowed the trader to generate commissions.

Why did this go so wrong?

As I discussed earlier, LIBOR setting involves a group of banks answering a hypothetical question.

This seemingly straightforward question actually embeds a good deal of ambiguity and room for potentially manipulative actions.

First, it is a hypothetical question - not what rate did you borrow at that morning, but what rate do you think you could borrow at.

This potential disconnect from actual borrowing activity builds in from the beginning a certain amount of judgment and room for manipulation.

Second, some of the parameters - "reasonable market size" or "just prior to 11 a.m." - also allow for subjective interpretation.

This type of judgment is not inherently a problem, but it does open the door for improper behavior and also makes transgressions more difficult to identify.

At the same time, and partly in response to the lessons learned during the financial crisis, patterns of bank funding began to shift away from unsecured funding to secured funding markets.

Investors and other market participants grew to prefer holding specific collateral against their loans - even very short-term loans - than just trusting in the ongoing viability of the borrower.

This shift had substantive implications for money markets and the LIBOR fixing model, which was based on the assumption that there would always be regular activity in unsecured interbank funding markets.

As those markets dried up - in some cases there were essentially no transactions for longer-dated tenors - it became harder for banks to ground their LIBOR submissions in actual, observable transactions.

This put a greater premium on a submitter's judgment, which increased the risk of further abuse and manipulation.

We have learned as well that compensation and hiring practices also helped to undermine the integrity of the reporting regime.

For example, we have seen that compensation and promotion within a bank are often tied to a trader's market share and profitability.

In addition, traders often move between firms so having a network of external contacts and being viewed as a team player could help to support job mobility.

Consequently, one can conclude that even the loss of a job is not necessarily a permanent setback, and that market participants with allegations of improper behavior could potentially move on to other firms with the expectation that they would generate revenue and profits for their new employer.

These incentives were amplified by the structure of the markets that underlie the setting of LIBOR and those that use LIBOR.

The interbank cash borrowing market that LIBOR references is very small relative to the enormous markets that use LIBOR, for example interest rate derivatives.

The standardization of settlement dates further concentrated trading activity.

In this type of environment, relatively small changes in LIBOR submissions - either because the actual borrowing costs fluctuate or a submitting bank intentionally misreports its submissions - can have substantive effects on a trader's profitability because the trader can hold large derivatives or futures positions that reference the cash LIBOR rate at the time these contracts settle.

Finally, and I think perhaps most importantly, the questionable behavioral norms in the industry - along with the weak control environments and compliance processes - that were uncovered during the investigations, exacerbated and facilitated the misalignment of incentives that are specific to LIBOR.

It is a sad state of affairs if unethical behavior is socialized among new traders with the explanation that this is business as usual, and, if compliance and risk management are inadequate as a counterweight to prevent or identify wrong-doing.

It is untenable if people working in compliance and risk are treated as second-class citizens relative to the firms' revenue generators.

The official sector response

The international regulatory community began to address these issues when the U.K. government published the Wheatley Review in September 2012.

The Review recommended a ten-point plan, subsequently accepted in full by the U.K. government, for comprehensive reform of LIBOR.

This led to many changes including the statutory regulation of the administration and submission process with respect to LIBOR, the selection of a new administrator for LIBOR, new governance and oversight regimes for the administrator and submission guidelines as well as a code of conduct for submitters.

The BBA, the former administrator for LIBOR, for example, eliminated publication of certain currency and tenor rates and delayed the publication of bank-specific submissions.

Perhaps most importantly, LIBOR-related activities are now subject to formal regulation and supervision in the U.K.

I support the changes initiated by the U.K. government and believe they have substantially strengthened LIBOR.

That said, I also believe that more work remains to be done to broaden the definition of LIBOR so that it represents the reality of new funding patterns for banks, and to also tie submissions more closely and systematically to observable transactions.

A second notable development was the publication of an international set of principles for financial benchmarks developed by the International Organization of Securities Commissions (IOSCO) in 2013.

These principles include a set of 19 specific standards across governance, benchmark quality, methodology and accountability that have emerged as the international standard.

IOSCO has rightly focused on tying benchmarks more closely to observable, arms-length transactions.

While a pure transactions-based rate will not solve all problems for all benchmarks, this is an important step toward eliminating excessive reliance on expert judgment.

As part of the international reform efforts, the Federal Reserve played a lead role in a set of recommendations for the reform of reference interest rates produced by the Financial Stability Board (FSB).

Former Governor Jeremy Stein, followed by Governor Jay Powell, co-chaired a working group with Martin Wheatley of the U.K. Financial Conduct Authority (FCA).

This working group was charged with reviewing existing interest rate benchmarks, and for establishing and guiding a group of market participants to identify the feasibility and viability of adopting alternative reference rates.

The FSB report was released in July and Governor Powell 11 has recently described the Federal Reserve's plans to support the two primary components of the reform of LIBOR.

First, we are considering, in cooperation with the LIBOR administrator and other members of the official sector, ways to broaden the definition of

LIBOR to more adequately represent current patterns of bank funding and to anchor it more firmly in observable transactions.

Second, we believe it is important for market participants to have access to a range of appropriately created and governed reference rates that best suit their particular business needs.

For example, some activities such as interest rate derivatives might be better served with a risk-free or near risk-free reference rate, rather than one that embeds a bank credit risk component.

I would like to emphasize three points in support of the FSB recommendations and our own efforts.

First, the FSB recommendations make clear that there is not one single path for all jurisdictions to achieve the common objective of more robust and resilient reference rates.

Rather, each jurisdiction must take into account its own specific institutional, legal and market practices and arrive at its own best solution.

In the U.S., I believe it is important to identify alternative reference rates that are grounded in a strong governance framework as laid out in the IOSCO principles and that are supported by market transactions.

This brings me to my second point - given a set of robust reference rates that meet IOSCO standards, the choice among these reference rates should be left to market participants who can best identify the specific rate that is most appropriate for a specific business need.

Third, the Federal Reserve is committed to working with market participants of all kinds - dealers, end users, legal and accounting experts - to help develop robust reference rates that meet the needs of all types of market participants.

In addition to these specific efforts around improving and finding alternative benchmarks, the New York Fed is sponsoring other efforts related to the reform of market practices and benchmark rates.

The Foreign Exchange Committee (FXC) and Treasury Market Practices Group (TMPG), for example, are two groups of senior market practitioners sponsored by the New York Fed that are working within their markets to identify best practices for trading and behavior related to benchmark rates.

Both groups also have published broader sets of best practices for the foreign exchange markets, and for Treasury, agency debt and agency MBS markets.

I would ask all market participants to ensure that these and other best practices guide the behavior that we should expect from participants in financial markets.

This will not be easy, but I believe restoring confidence in reference rates is achievable and will greatly enhance the robustness and resilience of our financial system.

I have focused here on the reform efforts around LIBOR, which is only one reference rate, albeit one that is widely used and a core part of our financial system.

But, the need for stronger governance and more accountability spreads much further within the set of benchmark rates, and further to encompass a wide range of practices within the financial system.

For example, accusations have recently surfaced related to business practices within foreign exchange markets.

While the concerns are technically very different than the practices uncovered around LIBOR submissions, the common theme is the willingness of a small number of market participants to behave improperly and contribute to a decline in confidence in the integrity of benchmark rates specifically and of major financial institutions more generally.

Next steps

I have discussed some of the observed problems in major reference rates that reflect egregious personal behavior.

Some individuals responded to poorly-designed incentives and weak controls at some of the largest financial institutions.

The regulatory community has already taken important steps to mitigate those concerns and real progress has been made.

While this has helped to restore some of the integrity of particular reference rates, such as LIBOR, more work needs to be done before confidence in these rates are put on a firmer foundation.

I'll conclude by emphasizing two of the next steps that I think are most essential for the successful reform of LIBOR.

First, the definition of LIBOR should be broadened so that it more accurately reflects the observed funding patterns of large banks and puts the rate on a broader, more stable base of observable transactions.

The LIBOR administrator is actively considering ways to do this while remaining true to the spirit of LIBOR and how it is used in financial contracts.

Accomplishing this will make markets that need a reference rate that embodies bank credit risk more robust and resilient and will strengthen the financial system.

Second, we still face the problem that the reference rate for a large stock of derivatives contracts is based on a relatively small, underlying cash market.

This means there still is a powerful incentive for individuals to attempt to manipulate the rate for their own gains.

One promising solution, outlined in Governor Powell's recent speech on reference rates, is to work with market participants to find an alternative reference rate that is based on a deeper underlying cash market and that meets the needs of all market participants.

Of course, any rate that serves as a critical financial benchmark must meet the principles for good governance and production outlined by IOSCO.

This combination - a more robust and resilient LIBOR for transactions that require a reference rate with a bank credit risk component and the development of an alternative reference rate for transactions like interest rate derivatives that don't - will strengthen our financial system and help undo some of the damage caused by earlier transgressions.

But this is only a necessary and not a sufficient set of conditions.

To achieve the outcome desired, financial institutions also need to have in place the appropriate incentives and controls.

Thank you for your attention. I would be happy to take a few questions.

The quest for stability - regulating and supervising banks

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Handelshochschule Leipzig, Leipzig

1. Introduction

Ladies and gentlemen

Thank you for inviting me to the Handelshochschule in Leipzig. It is a pleasure to be here.

First of all, let me tell you a short story I heard the other day.

A young banker decided to get his first tailor-made suit.

As he tried it on, he reached down to put his hands in the pockets but, to his surprise, found none.

He mentioned this to the tailor, who asked him, "You're a banker, right?".

The young man answered, "Yes, I am.", to which the tailor replied, "Well, whoever heard of a banker putting his hand in his own pocket?".

It is certainly true that the reputation of bankers has suffered during the crisis.

But still, banks and savings institutions play a vital role in any modern economy and, indeed, in our everyday lives.

We simply could not manage without them.

Entrepreneurs, bankers and individuals alike: we all benefit from a stable banking and financial system.

Financial stability is therefore a public good, not just nationally but on a global scale, too.

At the same time, banking can sometimes be associated with external effects.

It doesn't just affect banks and their business associates; it also has an impact on third parties with no stake in the game.

And during the financial crisis, those third parties were the taxpayers.

Regulators and supervisors can rectify a market failure of this kind, and it is in the public interest for them to do just that. It isn't a question of whether but of how to regulate.

And it is this matter of how to regulate that I would like to discuss now - not by focusing on specific legal provisions, but by outlining certain principles which I consider particularly important.

2. Regulating banks

What is the job of regulators?

Well, in a nutshell, their job is to create a framework that allows market forces to produce efficient outcomes while also preventing instability and crises.

Yet it is vital to ensure that this framework is not overly rigid; we should not confuse stagnation with stability.

The financial system is in constant flux, and regulation has to keep pace with it.

The regulatory framework therefore needs to be just as adaptable as the financial system itself - this is the first principle on my list.

It is now widely accepted that innovations rarely make the financial system simpler and usually make it more complex.

The key financial innovation in the ancient Phoenician civilisation was the forward transaction - a financial instrument that every student of financial economics is familiar with today.

Since then, financial innovations have become increasingly complex - to the point where the instruments used today are often understood by only a handful of experts.

But does that mean that we need increasingly complex regulation, too?

Or could it be that we need only a few simple rules to ensure effective supervision and safeguard financial stability?

One current example of this debate concerning simple and complex regulation is the leverage ratio.

The advocates of a simple leverage ratio for banks want to replace the current risk-based capital rules with a "blanket" capital requirement.

They believe that the same percentage of capital should be held against all assets, regardless of their risk.

I have to admit that the idea appears appealingly simple at first sight.

And it would avoid the mistakes and manipulation that can arise during the complex process of calculating risk weights.

Yet a leverage ratio would also create the wrong incentives.

If banks had to hold the same percentage of capital against all assets, any institution wanting to maximise its profits would probably invest in high-risk assets, as they produce particularly high returns.

This would eradicate the corrective influence of capital cover in reducing risk.

Weighing up the advantages and disadvantages of simple and complex regulation, it is probably better in this instance to use risk weightings in combination with the leverage ratio - which is precisely what the new rules envisage.

Consequently, the second principle of good regulation is that regulation must be as simple as possible and as complex as necessary.

Yet sometimes a certain set of circumstances can make regulation needlessly complex.

One example of this is again the leverage ratio.

The calculation of this ratio, which is essentially quite simple, is complicated by the fact that accounting standards vary from country to country.

Intricate conversion calculations are needed to make leverage ratios based on US accounting principles comparable to those based on the standards used in Europe.

If accounting standards were harmonised at a global level, the applicable regulation would be simpler.

However, the more complex the regulation, the more important it is to adhere to the third principle on my list: coherence.

I believe that regulation must be coherent on at least three levels.

First, regulation has to be coherent across borders and regions.

We have a global financial system, and it therefore requires global regulation.

Where regulation varies from country to country, there is a danger of regulatory arbitrage - of banks moving their business to countries with the lightest-touch regulation.

The problem with this behaviour is that the risks stemming from these transactions could potentially affect the entire financial system.

This is why the G20 have made the issue of financial market regulation a priority.

In cooperation with the Financial Stability Board and the Basel Committee on Banking Supervision, they are working to develop a coherent regulatory framework at the global level.

Even so, I'm concerned to see that some countries outside Europe are adopting their own regulatory initiatives which breach the principle of cross-border coherence.

I believe that the danger of banking regulation one day returning to the principle of "every man for himself" needs to be taken seriously.

Yet regulation not only needs to be coherent across borders and regions but also across different sectors.

Here, too, the central issue is the danger of regulatory arbitrage.

One current example is the growth of the shadow banking industry, where financial enterprises conduct business which creates bank-like risks but is either regulated insufficiently or not at all.

In many cases, these risks are not even recorded.

Yet the shadow banking industry may become a source of systemic risk.

We therefore need to expand the regulatory framework in this area to ensure that it is coherent.

Third, it goes without saying that the content of regulation also needs to be coherent.

The capital rules are a case in point.

Unlike for all other forms of credit, banks do not have to hold capital against government bonds in line with the risks that they carry, and this inconsistency has dangerous side-effects.

Since the euro-area sovereign debt crisis - if not before - it has become clear that government bonds are anything but risk-free.

In this area too, we should work to restore the coherence of regulation in the medium term.

As crucial as coherence is, however, regulation also has to be guided by a fourth principle: proportionality.

It is appropriate to apply strict regulation to large institutions which are closely interconnected within the financial system.

Equally, however, we must take care not to overburden small and medium-sized institutions; they should be governed by simpler regulation.

The standardised approaches applied in supervision and de minimis thresholds such as those used in reporting can help us to achieve this proportionality.

Ladies and gentlemen, I've outlined four different principles for ensuring good regulation.

- First, regulation has to be flexible and able to keep pace with developments in the financial system.

- Second, regulation must be as simple as possible and as complex as necessary.

- Third, regulation has to be coherent in terms of its content, as well as across borders, regions and sectors.

- Fourth, regulation must be guided by the principle of proportionality.

Abiding by these principles will not, of course, allow us to solve every single regulatory problem.

Yet they do provide us with a yardstick for assessing regulatory provisions.

And I believe that is very valuable in our quest for stability.

3. Supervising banks

All in all, though, even the best regulation is useless if nobody is overseeing compliance.

And that is precisely the job of supervisors.

Supervisors have to make sure that, in the banks' search for profit, they follow the rules and do not lose sight of the public interest.

Do supervisors have to be the "better bankers"?

No, absolutely not.

Business decisions must be left to those being paid to make them.

However, supervisors have to know - and understand - how banking works.

Against this background, I personally would very much welcome an increase in the migration of staff between the banking industry and the supervisory agencies.

In 2010, the IMF published a paper entitled: "The Making of Good Supervision: Learning to Say No ".

This idea of "saying no" refers to the fact that good supervisors must have the will to act.

This means that they must always remain aware of their true objective: to uphold the public interest.

They must not allow themselves to succumb to a sort of "Stockholm Syndrome for supervisors" and confuse the public good with that of the supervised banks.

Nevertheless, supervisors must not only be willing but also able to act.

Let me give you an example.

It certainly isn't the job of supervisors to keep each and every bank in business.

In a market economy, it has to be possible for banks without a workable business model to fail.

However, if banks are very large or interconnected, their failure might disrupt the whole system - they become "too big to fail".

The ability of supervisors to resolve the bank in question is then very limited.

In fact, the authorities might be forced to bail out the bank with taxpayer funds in order to prevent a systemic meltdown.

Regulators therefore have to create a framework that gives supervisors the ability to act.

They must be able to resolve or restructure a failing bank - however large, interconnected or significant it may be.

Over the past few years we have made some progress toward this objective.

In Europe, a resolution mechanism for banks will be in place from the beginning of 2016.

However, we also have to address the "too big to fail" problem at the global level.

We have taken some small steps towards this goal but we still have a big leap ahead of us.

I therefore consider the "too big to fail" problem largely unresolved.

But let's return to the issue of good banking supervision.

Good supervisors need both the will and the ability to act.

My example illustrates how the ability to act depends on the regulatory framework. But there is more.

Both the will and the ability to act also depend on the institutional set-up of banking supervision.

And in this area, Europe is on the eve of a major change.

One month from now, banking supervision in Europe will be transferred from the national to the European level.

On 4 November, the ECB will take on the direct supervision of the largest 120 banks in the euro area.

These banks account for more than 80 % of the aggregated balance sheet for the euro-area banking sector.

This will make the ECB one of the world's largest supervisors.

European-level supervision is the most important step towards financial market integration in the euro area since the launch of our single currency.

It is a logical step, too, since a single monetary policy also requires integrated financial markets - which includes, without doubt, European-level supervision.

European banking supervision will allow banks throughout the euro area to be supervised according to the same high standards.

In addition, cross-border effects can be covered better through joint supervision than by national supervisors.

And adding a European perspective to the national view will put more distance between the supervisory authority and the entities it supervises.

This will minimise the danger of supervisors getting all-too-close to their banks and thus treating them with "kid gloves" out of national interest.

European banking supervision will thus enhance the effectiveness of banking supervision.

And, together with the European resolution mechanism for banks, it will definitely help to increase the stability of the financial system.

4. Conclusion and outlook

Ladies and gentlemen, the French writer François Fénelon once claimed that, "the more you say, the less people remember".

As this obviously isn't my aim, I would like to conclude my remarks by taking a peek into the future.

The past history of regulation has been one of constant ups and downs.

Periods of deregulation have usually been followed by a crisis, then followed by a period of re-regulation, and again by a period of deregulation.

It is precisely in phases of re-regulation that banks tend to complain about the time and money it costs - and the present period is no exception.

But are we really overregulating?

If we look at the benefits to society of a stable banking system and the social costs of a banking crisis, I believe the costs of regulation are justifiable.

However, for the future I would like regulation to evolve somewhat more steadily and adapt more quickly to new challenges: the low-interest-rate phase, high-frequency trading, charges of manipulating the LIBOR or the setting of forex rates and gold prices, to name just a few examples.

We should not wait until the aftermath of the next crisis to come up with ways of responding to these challenges.

I do not believe, however, that regulators and supervisors are all-knowing and all-powerful.

The bankers are just as responsible as the supervisors and regulators.

I am well aware that the number of "bad apples" among bankers is very small.

However, their behaviour causes everybody to suffer: the public, when a crisis breaks out, and the bankers, when the public tar them all with the same brush.

Yet we should be aware that the value of the financial system is measurable against one key criterion: its reliability as a service provider to the real economy.

Financial transactions are not an end in themselves. If we can instil this idea in people's minds, we'll be able to take the final key step in our quest for greater stability.

Thank you very much.

Microprudential, macroprudential and monetary policy: conflict, compromise or co-ordination?

BANK OF ENGLAND

Speech

Speech given by Paul Fisher, Deputy Head of the PRA, Executive Director, Supervisory Risk Specialists and Regulatory Operations; Executive Director, Insurance Supervision.

Thank you for inviting me once again to speak at Richmond University. In the last year I have moved within the Bank of England from the Markets Directorate to the Prudential Regulation Authority (PRA) and from the Monetary Policy Committee (MPC) to the PRA Board.

The PRA Board is one of our three formal policy committees, and makes the highest level supervisory decisions for those firms authorised by the PRA.

That includes insurance companies, banks, building societies, credit unions and major investment firms.

I have been attending meetings since June and will become a voting member in due course.

Having previously also served on the interim Financial Policy Committee (FPC) for 2 years, and the MPC for 5 years, I want to use this lecture today to set out how the three policy committees of the Bank work together.

I have seen and heard assertions in the press and other commentary that the three committees with their different objectives will inevitably be in conflict.

Whilst there are many difficult policy challenges for each of the committees, and different judgements can be reached by reasonable people on any policy question, I will argue today that conflict is not inherent in the structure in the sense of having to choose between competing objectives.

There should not be any compromise in terms of achieving those objectives over the medium term, even if the actual setting of each policy lever needs to take others into account.

The key to realising this outcome is effective co-ordination.

Much of the economics literature around policy co-ordination traditionally focussed on two problems: the coordination of monetary and fiscal policy, especially in the case of an independent central bank; and international macroeconomic policy co-ordination.

In the past decade or so there has been rather more on inter-institutional coordination.

I will be drawing on that body of established workand applying it to the challenge of co-ordination faced by the Bank's three policy committees: the MPC, the FPC and the PRA Board.

First, what are their objectives?

• The MPC's objective is to deliver price stability – defined by the Government's inflation target of 2% – and, subject to that, to support the Government's economic objectives including those for growth and employment.

• The FPC's objective is to protect and enhance the stability of the financial system of the UK – and, subject to that, to support the Government's economic objectives including those for growth and employment.

• The PRA has two statutory objectives: to promote the safety and soundness of deposit takers, insurers and major investment firms and, specifically for insurers, to contribute to the securing of an appropriate degree of protection for policyholders.

It also has a secondary objective, to facilitate effective competition in the markets for services provided by PRA-authorised firms.

The PRA Board

The PRA Board is the least well known of the 3 committees and so I want to say a few words about how it operates.

I have been attending as an observer since I moved to the PRA on 1 June.

The Board is constituted in a similar way to the other committees in that it is chaired by the Governor and has both internal executive members and externally appointed independent members.

On the basis of current announcements it will have a total of 5 internal members, and 6 independent members including the CEO of the Financial Conduct Authority (FCA).

It meets approximately twice a month for formal meetings.

In summary, the Board is responsible for meeting the PRA's statutory objectives, including taking all the major supervisory decisions for the 1700 or so firms and groups it authorizes; formulates regulatory policy to meet those objectives; and has a range of strategic and management responsibilities including delegating some matters, principally to the CEO of the PRA or to formal PRA committees.

Matters reserved to the Board and its delegations can be found in documentation on the Bank's website via a link in this text.

In what follows I shall treat the PRA Board and the PRA as one policy making body, referring to one or the other as best fits the context.

Before moving on, it is worth completing the picture by noting that the PRA works alongside the FCA, creating what is known as a "twin peaks" regulatory structure in the UK.

The FCA is a separate institution and not part of the Bank of England.

It is responsible for promoting effective competition, ensuring that relevant markets function well, and for the conduct regulation of all financial services firms including all those authorised and regulated by the PRA.

This includes acting to prevent market abuse and ensuring that consumers get a fair deal from financial firms.

The FCA also operates the prudential regulation of financial services firms not supervised by the PRA, such as asset managers and independent financial advisers.

In consequence it regulates a much larger number of firms than the PRA – over 50,000.

But the FCA and PRA have a joint MoU and co-operate closely on a range of matters, most especially for those firms which are regulated by both ie by the PRA for prudential matters and by the FCA for conduct.

Policy co-ordination basics

The theoretical conditions under which one can achieve a number of different economic policy objectives at the same time was long ago embedded in the Tinbergen counting rule, named after the great Dutch Nobel prize winning economist.

A necessary condition is that there should be at least as many independent and effective policy instruments as there are independent policy targets.

By an instrument I mean any policy setting which can be changed: such as Bank Rate or the required amount of capital to be held by firms.

To be satisfied, the Tinbergen rule requires that the policy tools being used must each have an impact on at least one of the objectives in sufficient size to make a substantial contribution towards achieving it.

And that the pattern of effects of one tool on all objectives cannot be perfectly reproduced by changing any other tools singly or in combination ie the policy tools are each unique in their precise pattern of effects.

Additional conditions are necessary if the objectives are assigned to different policy making bodies.

So I will add a number of other sufficient conditions to cover this case.

- Each policy tool should be assigned to meeting a target that it is relatively effective upon (ie to exploit comparative advantage).

This may seem obvious, but is less so if one is uncertain about a particular policy's effectiveness.

If a policy is not very effective on its primary objective, one of the consequences could be unnecessarily large policy changes.

- The authorities need to be able to co-ordinate or communicate in some way about what they are doing and why.

Otherwise one can show that there is a risk in some circumstances of a dynamic being created which is destabilising (eg where one authority tries to offset the effects of another in turn).

- And perhaps most importantly, the targets need to be achievable & coherent as a set.

Let me explore this last point briefly by taking an extreme case.

If the MPC were to be set a target of absolute zero unemployment, that would be physically impossible and however hard they tried, it would not be achieved.

If they did try hard nevertheless, it would probably lead to an over-expansion of the economy that threatened both financial stability and prudential safety and soundness.

In a less extreme case one could imagine an MPC target for money supply growth which, given time-varying shocks to the velocity of money, might not be consistent with the other objectives.

Applying these conditions to the UK Authorities

So the first question I want to ask is whether the MPC, FPC and PRA Board have been set an achievable and coherent set of targets?

Is it possible to achieve CPI inflation at 2%, financial stability, and safety and soundness of firms simultaneously?

I assert that there is no inherent absolute conflict – these are different elements that can be associated with a single economic equilibrium.

In the absence of events, random shocks or other disturbances, it would be possible to achieve that triple objective simultaneously.

If that were not possible, there would be a truly deep conflict, and the only solution would be to go back to government and ask for the remits to be changed so that coherency was achieved.

I see no arguments to support that.

But even though the different policy objectives can be achieved simultaneously, that does not mean that each committee can ignore the others.

That would only be true in a special case when use of each committee's policy tools affected its own objectives and not those of others ie if the policy effects were perfectly independent.

In practice independence is inevitably partial: each policy tool is likely to affect all the objectives, albeit in different degrees. In this general case, the choices of one committee will affect the choices of the others.

An example of this was when the MPC, in giving it's forward guidance on monetary policy, included a financial stability 'knockout' – acknowledging explicitly that there might be circumstances when monetary policy settings had to reflect the risks to financial stability.

That interaction or 'spillover' is not the same as having a conflict between the objectives.

Policy spillovers will be reflected in adjustments to the precise settings of policy levers at particular moments in time, but should not compromise achievement of the ultimate objectives.

But to keep on course for multiple objectives certainly requires co-operation to reflect these policy interactions.

One aspect of this co-ordination is a common understanding of the economy.

For example, the gap between actual and potential output levels could have an important bearing on policy settings for each committee.

If the three committees had different views about the size of that gap or just different economic models, then they could set inconsistent policies.

That would be a conflict of judgements – not a conflict of objectives.

The presence in the Bank of a single forecasting function and cross-use of its outputs, helps to avoid that particular trap.

Any single central forecast would still most likely be wrong of course, but the committees will learn about changes to the outlook consistently, allowing consistent policy adjustments.

Another angle to cooperation arises from the 'long and variable lags' in the economy – and not just in the monetary transmission process.

Each committee can face very long and uncertain lags between deciding to take a policy action and the maximal impact on its objective.

That makes it unlikely that any one objective can be achieved precisely at all points in time.

As well as predictable lags, policy outcomes are subject to all sorts of random disturbances that constantly require changes to policy settings.

Suppose, however, a committee actually tried to obtain its objectives at every moment in time regardless.

That would likely necessitate wild swings in policy settings: imagine the MPC trying to set Bank Rate so that 2% inflation was achieved exactly every month!

Not only would it quickly prove impossible, attempting the feat would drastically reduce the chances of the other committees achieving their objectives.

So a degree of humility is required by each committee, for the sake of coordination as well as the credibility of each.

In their commitments to hit their statutory primary objectives I would say that:

- The MPC should not be 'inflation nutters'.

- The FPC should not seek the 'stability of the graveyard'.

- The PRA Board should not seek to implement a 'zero failure regime'.

That is supported helpfully by the secondary objectives of each policy maker.

One can interpret them in several ways, but to me they help put the primary objectives in an overall context.

We want all three objectives to be met in an economy which is growing at its maximum sustainable potential.

Excessive zeal in meeting any primary objective too quickly could act, not just to slow actual growth, but reduce sustainable potential and this is important to keep in mind.

Cooperation and coordination are generated in the framework by several structures.

Essentially, these are about information sharing.

The most important is via cross-committee membership: the Governor chairs all three committees, and there is further cross-membership of internal members.

And there is also joint briefing meetings/staff support.

The Strategic Plan of the Bank announced earlier this year, is designed in part to enable the different policy functions of the Bank to work more effectively together, reducing overlap and exploiting synergies.

A notable example of policy co-ordination across the Bank's committees has been on the question of housing.

Rising house prices could generate rising debt levels over time, creating risks to monetary stability as well as financial stability and the safety and soundness of firms.

But addressing this by trying to adjust Bank Rate would potentially adversely affect the whole of domestic demand at a time of economic recovery and low price inflation, and it could have needed a very large change in Bank Rate as it is not very effective in controlling house prices.

At the end of June, the Bank announced a set of macroprudential actions designed to mitigate the risks from the housing market (not to control house prices per se).

The Bank was able to construct policies which would operate directly on the flow of debt arising as a result of the housing market.

It was clear that the FPC should take the lead in using these tools, but drawing on a common macroeconomic assessment (provided by the MPC's forecast, with policy analysis coming jointly from across the Bank) and a micro assessment provided by the PRA.

The FPC could then set the overall macroprudential parameters by a Recommendation, with the particular policies being implemented by supervisory processes consistent with the PRA's objectives, and by the rules of the FCA.

Indeed it is worth noting at this point that the coordination circle does include the FCA – the CEO of which sits on both the FPC and the PRA Board.

One could extend the three-committee analysis in this lecture to four.

That brings us to the question of the policy levers themselves.

Is it the case that each committee has instruments which are both sufficiently effective and independent?

The MPC clearly has strong influence over the price and quantity of money.

Bank Rate is a basic price of money: the rate paid to commercial banks on their reserve holdings at the Bank of England.

The quantity of narrow money (those reserve holdings plus banknotes in issue) is also set by control of the Bank's balance sheet: either by adjusting the stock of purchased assets or by adjusting the stock of secured lending to the banking system.

In respect of this latter policy lever, the Bank's executive and its board of directors (Court) are ultimately responsible for management of the Bank's balance sheet, but there are formal agreements in place such that if operations need to be conducted for monetary or financial stability motivations, then the appropriate committees are consulted and will ultimately will make the decision.

Distinguishing the FPC and PRA's instruments takes us into more interesting territory.

The FPC can make recommendations to pretty much anyone about anything that would help meet its objectives.

That's very wide ranging but effectiveness depends on those recommendations being accepted and implemented.

That can only be guaranteed where there is effective coordination between the FPC and those to whom the recommendations are made. PRA, FCA, Bank and HMT all fall into that category.

The FPC's most enforceable powers (of direction) relate to setting the counter-cyclical capital buffer and sectoral capital requirements which they can direct the PRA to implement across all deposit takers.

A leverage ratio is likely to be added in due course and the Government have also stated that they intend to grant other powers to the FPC to ensure that it has sufficient policies to address issues arising from the housing market.

Capital and liquidity requirements are the most basic tools for controlling the banking system in aggregate.

Superficially, and taking directions and recommendations together, the FPC could therefore be interpreted as undertaking coordinated supervision.

If that were the case, the question must arise whether the PRA has any independent instruments and whether the FPC and PRA Board arrangements mean that both can achieve their objectives.

Specifically, does the FPC dominate the PRA?

The answer of 'no' comes in two parts.

First, beyond the formal powers of direction, the FPC can make recommendations on a wide ranging basis.

Only the PRA and FCA may be obliged to respond10, but in principle, the FPC could seek to involve itself in much wider matters than those over which the PRA has legal powers.

Second, the FPC cannot involve itself in matters relating to specific firms. For example, ultimately only the PRA Board can sign off on what levels of capital an individual deposit taker must hold, adding their independent judgements to the minima which are set by a combination of international standards and any FPC decisions.

Those judgements reflect the specific risks being faced by individual firms and there are a range of factors, any of which may cause a capital requirement to be made.

The PRA's judgemental approach to supervision is set out in its Approach Documents for Insurance and Deposit Takers which are published on our website.

In exercising its authority, following its published approaches, the PRA also makes judgements around a broad set of firm-specific factors that the FPC would not be involved in: risks not captured in the formal capital definitions, senior appointments, approving specific transactions, risk and governance controls etc.

In short the FPC makes decisions to ensure financial stability in the system as a whole and the PRA acts to support the safety and soundness of individual firms.

But the PRA approach to supervision also involves other considerations.

I have already mentioned that we must not operate a 'zero failure' regime.

That was in the context of not taking extreme decisions in over-zealous pursuit of our objectives.

But if investors and other market participants believe that supervisory effectiveness leads to a situation in which a firm cannot fail, then they will likely take inappropriate exposures to those firms and the market will become distorted.

In particular if a firm is likely to be bailed out by the public sector then that reduction in risk means that firms will have to pay less for their liabilities – giving them an implicit subsidy.

That has been discussed at length in a number of Bank publications, but a key point for today is the Bank's continuing commitment to end the

'Too Big to Fail' problem and, specifically, to seek to establish realistic recovery and resolution plans for the firms it authorises.

That consideration also affects supervisory decisions on legal entity structures, transactions, senior persons and so on.

In short, the FPC and PRA have many different, independent policy decisions to make.

Ensuring both financial stability and safety and soundness of firms, requires both policy sets.

The issue is sometimes raised as to how systemic stability and safety and soundness interact – especially during or after a financial downturn, when defensive actions by financial firms may be pro-cyclical.

This is perhaps the period when cooperation and communication between the committees comes to the fore most strikingly, and forward guidance on policy can be most effective and necessary.

The FPC and MPC will want to make sure that the regulatory system is not pro-cyclical – they will want to avoid anything that reduces the capacity for credit creation when the wider economy needs most support from its financial sector.

It is often asserted that requiring firms to hold more capital automatically reduces the capacity to lend.

That is not the case.

Capital is a source of funding and sits on the liability side of the balance sheet.

What matters is how a firm goes about improving its capital ratios.

Reducing lending is only one way of adjusting a capital ratio up.

As well as raising new capital, retaining more cash, rather than paying dividends or staff bonuses, can also contribute.

And it turns out that, at the start of the financial crisis, the larger banks had many non-core assets on their balance sheets, beyond lending to households or non-financial companies.

In the past few years, capital positions have been rebuilt in many firms by running down or selling on these other, non-core assets, rather than seeking to reduce direct lending to households and businesses.

The regulatory action most likely to affect the capacity to lend is that of increasing liquidity requirements – liquid assets obviously do compete with other assets on the balance sheet including less liquid loans.

But in a proximate sense, most firms fail not at the point when they have run out of capital, but when they run out of cash (although the latter may be a forward indicator of the former).

Firms holding enough liquidity in reserve is a crucial defence in maintaining a robust financial system and hence financial and monetary stability.

The key to solving this policy dilemma is to make sure that firms hold enough liquidity (and capital) in the good times so that, when a downturn hits, supervisors can take a relaxed view about firms using those holdings as buffers to absorb the macro shock.

That was not the position post 2008/09 when banks had not been holding enough liquidity or capital in the good times.

It is an aim of the new regulatory frameworks put in place post-crisis, that banks should hold bigger liquidity buffers in normal times.

The Bank of England's balance sheet can also be used actively to backstop liquidity for the system as a whole, via the banking system, and the new operating frameworks put in place over the past 5 years will allow that to happen more quickly and easily.

How will this all co-ordinate in practice?

When the Bank, HMT and FSA took joint action in 2012 to reignite the recovery via the Funding for Lending Scheme – reviewed in my two previous talks to you – the FSA, as predecessor to the PRA and having two members on the interim FPC, contributed by relaxing liquidity requirements and making it clear that liquidity buffers were there to be used.

This was a crucial element of the package.

Coherence vs Agreement

I believe I have set out so far a reasoned view that the three Bank policy Committees – the MPC, FPC and PRA have a coherent set of objectives, structures, appropriate policy tools and coordination to ensure that there is not any inherent absolute conflict in the framework.

And the strategic changes internally at the Bank announced earlier this year could be seen as being a reinforcement to that structure by maximising the synergies across the Bank, including the PRA.

But coherence doesn't always mean agreement.

There will no doubt be disagreements at some point.

Indeed, the appointment of independent members to the policy committees is intended to ensure challenge and the absence of 'group-think'.

Dissenting views on the MPC are not only an established part of the culture but actively encouraged by the Treasury Committee in Parliament.

The FPC and PRA Board, in contrast, generally work by consensus, although there are provisions for recording dissent and votes if necessary. But disagreements over judgements between individuals are normal – that's why we have decision making by committee in the first place.

What we have not seen is any reason why the structure should be regarded as internally conflicted.

How likely is it that there will be dissent across committees?

There are mitigants in place to reduce the chances of that.

Cross-chairmanship and membership from Bank executives should enable us to keep to coherent policies even when there are differences of opinion.

And I say that - despite evidence from operation of the MPC where there has generally been as much dissent recorded between the Bank executive members as by the independent members - because we have a collective institutional need to make the whole framework function in the best interests of the UK economy.

And another structural way of addressing divergent views is to have joint meetings and briefings on the issues which have most cross-over, which help bring the different externally appointed members together.

That has already happened successfully on several issues, most notably housing.

Concluding Remarks

It is important that we give the new structure time to work.

First, because we will learn a lot.

If there are flaws – and it would be reasonable to think there will be some - we need a bit of time to identify them and iron them out.

Macroprudential tools are being used in the UK for the first time.

And the PRA's new approach to supervision is still being embedded.

Second, the regulatory reform agenda is still being decided and implemented internationally – insurance regulation in particular has a long way to go to set truly global standards.

Measures to tackle Too-Big-to-Fail are still being finalised.

So we are still some way from having a stable international regime within which to operate.

Third, policy changes take time to have their effect.

Indeed, the experience of monetary policy over the past few years demonstrates the need for patience.

As well as addressing the issues around policy coordination, I hope I have also drawn your attention today to some aspects of how the PRA and its Board work.

These are not secrets, and there is a wealth of information already published.

But prudential supervision tends not to attract the same public attention as monetary policy unless something goes wrong.

The work of the PRA and its Board is nevertheless a vital and distinct part of the new system and we need to be as open and transparent about our role, policies and operating procedures as we can be.

National supervision in a European system - what is the new balance?

Speech Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank, at the Fifth FMA (Austrian financial market authority) supervisory conference, Vienna

Mr Ettl, Mr Kumpfmüller, Ladies and gentlemen,

Nine months ago to the day, the Finanzmarktaufsicht (Austrian financial market authority or FMA) issued two press releases announcing major "restructuring measures".

According to the FMA, banking supervision in the euro area would be built on "new foundations" in 2014 and the year would bring new tasks and challenges.

I really like the building site metaphor.

It isn't hard to imagine what the challenge of laying new foundations and constructing a new building - especially during regular operations - means.

This event today is about national supervision in a European system and where the new balance lies.

The focus is therefore on the stability of the European supervisory building.

Now, there are clear rules or conditions to be complied with when constructing a building.

Tasks and responsibilities must be clearly defined.

Everybody needs to know what to do or to leave alone - and that goes for the Single Supervisory Mechanism (SSM), too.

The European supervisory building, consisting of the ECB and 19 national supervisors, isn't a single family home, but a large building complex; a structure that should be sturdy and stable, even in stormy conditions.

Expectations of the developer

European legislators and the public, too, expect the SSM to ensure a resistant, robust banking system in the euro area. Supervision in Europe is rightly expected to be better than what 19 national supervisors could achieve with national means.

The new system of supervision should be neutral and not wedded to national thinking and traditions.

It should, where appropriate, produce a level playing field.

It had become apparent in the financial crisis that the difficulties of large, strongly interlinked banks were not just a national problem and that difficulties can spill over into the public sector and the real economy.

The SSM is supposed to identify any risks that may endanger national financial markets or the European financial market as a whole at an early stage and take measures to counter them. It should be assertive and able to act.

If it is set up properly, the SSM can indeed meet the majority of these expectations.

A European supervisory body will be able to identify risks early on and act effectively.

The SSM will be in a position to provide a considerable part of what a supervisor can do for a resistant banking system.

Among other things, the division of tasks between national supervisors and the ECB will ensure this.

But not all the developer's wishes can be fulfilled or are feasible, as the resistance of the European banking system or the performance of a national credit institution don't just depend on the supervisor's performance and ability to act.

In order to be resistant in the long term, a bank needs a sustainable business model; it needs sufficient income in order to bear the risks associated with banking.

After all, it shouldn't be forgotten that the balance sheet of a bank - especially a bank with extensive corporate banking - is always a reflection of the economies in which it operates as a financial service provider.

Construction planning - dimensioning the building

But let's leave the expectations and go back to the building itself.

At the beginning of every construction project is the planning.

The architect has to bring the wishes and expectations of the developer into line with all kinds of existing restrictions.

The final purpose of the building needs to be clearly defined.

With regard to the SSM, this means that, for practical reasons, direct supervision of all institutions in the euro area was neither feasible nor wanted right from the outset.

Fully centralised supervision would've had the considerable disadvantages associated with an organisation being too large, the resultant burdens for all concerned - which would be considerable - and a loss of national and regional expertise concerning the specific characteristics of banks in the Member States.

What added value would have been brought by direct ECB supervision of the many smaller institutions, which often have regional roots?
What challenges would've arisen in terms of linguistics alone?

After all, without having a detailed look at a large number of credit files, it isn't possible to properly supervise most of the banks which are active in private and corporate banking.

National language skills are indispensable here for discussions with the Executive Board and employees, as well as for looking into the files.

Furthermore, it wouldn't have been feasible to set up direct supervision of all banks in the euro area within a year.

As you can see, ladies and gentlemen, when it came to the dimensions of our building, it was once again a question of striking a balance between the advantages and disadvantages of a central or decentral solution.

For supervision to function in the euro area, a balanced relationship must be achieved between centralisation and regionality.

Making the building as big as possible must not, then, be an end in itself, because the foundations for this are lacking.

Significant institutions

The architects of the SSM thus decided that only the largest banking groups with cross-border activities in the euro area should be directly supervised by the ECB.

The national supervisory authorities in the euro area countries will thus continue to be the main contact for the remaining banks.

So the SSM will directly supervise what are known as significant institutions.

This category consists of 120 banking groups with around 1,200 individual institutions, which hold more than 80% of the total banking assets in the euro area.

If things were to get difficult, these banks could have a significant impact on the stability of the financial system in the euro area.

Eight of these banking groups are Austrian.

Less significant institutions

All 3,500 other institutions will be indirectly supervised by the ECB.

The decisive point is that the national supervisor remains the direct contact for the credit institutions and generally takes the associated supervisory decisions.

But there will also be some changes in terms of the supervision of less significant institutions, because the SSM will influence the supervisory approach of the national supervisors.

Through rules, guidelines and recommendations, the SSM will steer the national supervision of less significant institutions.

The aim of this is not to make everything the same; it is rather to ensure that a uniformly high level of supervision is achieved in the euro area. The sole aim must be to ensure a level playing field for all and to prevent blind spots on the supervisory map.

The term less significant institutions is, in fact, misleading.

There are certainly countries where individual institutions are not in themselves systemically relevant, but where the same cannot be said for these institutions taken together.

In addition, the less significant institutions do not all look alike.

They have balance sheets ranging from a few million euro to almost 30 billion.

Some less significant institutions operate on a purely regional level, with business models that are sometimes very simple, but sometimes very specific, while others are cross-border institutions with very complex business models.

The range is huge.

The same is true of their characteristics and distribution in the euro area.

Owing to their numerous cooperative banks and savings banks, Germany (with 48.2% of such institutions) and Austria (with 564 banks, accounting for 16% of such institutions and 8% of banking assets in the euro area) are home to the majority of less significant institutions.

This makes Austria our second largest "customer", after Germany, in the area of indirect supervision.

At the same time, there are countries that have very few such institutions: Cyprus, for example, will have seven such institutions in the SSM.

What does indirect supervision mean?

Let me say a few words on what indirect supervision actually means.

Indirect supervision by the ECB consists of two elements, macro-prudential supervision and supervision of institutions and sectors.

Macro-prudential supervision aims to identify and address deficits, in particular by comparing or benchmarking the various supervisory systems and approaches, and to spread and enforce best practice approaches.

Institutional and sectoral supervision are about the institutions prioritising their levels of risk and the possible effects accordingly, thereby defining the intensity of the indirect supervision.

Depending on which "class" of intensity the bank is in, the content of the reports will change in agreement with the various national supervisors.

For example, we're currently working on the draft of a reporting guide for national supervisors.
This guide should provide an overview of the information the ECB requires.

After all, indirect supervision isn't possible without information, unfortunately.

The reporting guide will be an expression of the multi-stage supervisory approach.

The reporting requirements are differentiated according to the prioritisation of the institution, the type of information to be provided and the reporting interval.

For example, we will put into a high "intensity class" those institutions that may have considerable adverse effects on the financial system of their Member State in the event of a crisis.

For these banks, we will supervise the activity of the national supervisory authority more intensively.

This way, the SSM can ensure high-quality supervision that follows uniform standards, even in individual cases, without subjecting each institution to an equally high intensity of supervision.

This applies first to those institutions that, as a first step, were classified by national supervisory authorities as institutions that require particularly intensive supervision.

In the not-too-distant future, however, there will be additional criteria, which will allow granular differentiation.

I'm thinking here, for example, of institutions for which early warning indicators are sounding or banks that are growing large enough naturally to be regarded as significant banks through balance sheet growth or increasing interconnectedness.

The consequence of the risk-oriented approach of institutional supervision is that the majority of the banks that, owing to their level of risk and their size, are classified as "low" or "medium" priority are subject to only very light supervision by the ECB.

This applies, for example, to the majority of cooperative banks and smaller savings banks.

For the new European system of supervision, however, a sectoral view will be added, which we will develop further in the next few years.

We want to identify institutions that together represent a concentration risk for the financial system and could therefore be systemically relevant as a group in the event of a crisis.

We describe these virtual groups as sectors. We will be paying particular attention to this group.

Resources of indirect supervision

To conclude the topic of dimensioning, I'd now like to say a few more words on the resources for indirect supervision in the SSM.

On the basis of uniform requirements, operational supervision for the 3,500 less significant banks has quite consciously been left to the national supervisory authorities.

The distribution of staff in the new European supervisory body also takes account of this basic idea: while around 400 supervisors will take care of the 120 significant banking groups at the ECB, operational national supervision of the 3,500 less significant institutions will be accompanied by approximately 80 members of staff at the ECB.

We are therefore quite consciously relying on the thousands of employees in the national supervisory authorities who, with their knowledge of specific regional characteristics, take care of this large group of banks on a daily basis.

Structural soundness

The construction plans are in place.
What regulations now need to be observed to ensure that the building is stable?

I believe that four fundamental technical requirements need to be fulfilled:

(1) First of all, a European supervisor needs a single legal basis which does not just determine the rules to be followed by the European banking sector, but also allows the supervisors scope for action.

Only then will we be able to create a level playing field within the SSM area.

The conditions for a single legal framework for banks and supervisors were put in place at the European level when the Capital Requirements Regulation (CRR) and the Capital Requirements Directive IV (CRD IV) entered into force on 1 January 2014.

In addition, the European Banking Authority (EBA) in London is working on a single rulebook, a single interpretation of the legal basis for European banking supervision.

This will take the form of binding technical standards on a variety of topics.

The European Regulation and Directive contain a number of national options and individual solutions in order to cater for specific national features.

If the European legislator has left it up to the national legislator to transpose these options - as is the case in around 20 instances - and the national legislator has done so in the form of a law, the SSM must respect this.

We have to apply national law, even if this might impair the level playing field.

The situation is different when the European legislator has left the exercise of national options to the discretion of the supervisor, as has been done in around 80 cases.

Over the past few months, we have made a list of all the national options and will come to a decision as soon as possible as to where we stand on every single one them, whether we will exercise them and if so, how.

The national supervisors will play an important role in this respect, as they are the ones that will have to explain the national features and the related risks to us.

They are the ones who should complement our knowledge of national markets and market structures, of national legal systems and risk trends.

And we know, as supervisors, that some of these options are the result not of specific market structures, but of the continued existence of old traditions and popular habits.

(2) Good supervision in Europe requires knowledge and experience of individual national as well as European markets and market structures; it requires knowledge and experience of national and European legal systems.

Knowledge should be consolidated and decisions taken centrally at the European level so that attention is focused on the European interest instead of on the solely national interest.

The division of tasks within the SSM provides for just that.

As I said, the ECB will take complete responsibility for the direct supervision of significant institutions. But national supervisors will bring their knowledge and experience to the supervisory teams and support the ECB in its supervision, and they will do so in line with a single supervisory approach.

It is our aim at the ECB to have detailed knowledge of the business model and risk profile of each of the 120 directly supervised institutions.

We want to be able to assess, at any time, the risk-bearing capacity, the internal control systems and the governance of banks, and to intervene at an early stage when we see danger.

In short, we intend to supervise intensively.

I have already spoken in detail about the division of labour with regard to the less significant institutions.

In both areas, then, knowledge of national and European markets will be brought together with a single evaluation system, a single supervisory approach and a central, European decision-maker.

(3) The third precondition for successful supervision in Europe is that macro-prudential oversight dovetails with micro-prudential supervision.

This is a case of complementing the supervision of credit institutions, which is very much concerned with individual circumstances, with important, well-prepared information that can only be obtained from the perspective of the euro area as a whole, or the global financial system.

It is not just in the supervision of internationally active banks that it is important for the supervisor to know what risks are emerging in the financial markets.

And looking at it from the other side, national supervisors can carry out the important task of identifying national incentive systems and channels of contagion. Such information makes it possible to intervene preventively and at a much earlier stage.

(4) The last and fourth condition for successful European supervision has to do with the SSM using the advantages of its size to the greatest advantage.

With powers of direct supervision over around 120 banks, the SSM has a broad knowledge base with which to identify risks at an early stage through cross-sectional analyses and comparisons.

For this reason the SSM will be able to rely on a strong horizontal function, which, together with the supervisors of the institutions, evaluates business and risk management practices at the banks and if need be formulates standards and establishes best practices.

Preparation for further extensions

A clever builder considers, even in the planning phase, whether it will be possible in future to meet requests to extend the building.

In the construction of the SSM European lawmakers have set clear rules on how EU Member States that are not part of the euro area can nonetheless become part of the SSM.

The rules for this close cooperation are there; so extensions are not out of the question!

And to this I am very open, well disposed, as long as they meet certain conditions.

The strict rules governing the construction of the main building must also be applied to extensions.

For this reason, close cooperation is not designed as an agreement between the ECB and the country in question, but as the result of an application that has been accepted.

If an EU Member State that does not use the euro wishes to participate in the SSM, it must create the legal basis enabling the SSM to issue instructions and guidelines to its national supervisory authority.

This is particularly important because, in non-euro area countries, the SSM cannot act directly vis-a-vis a credit institution but implements its decisions indirectly, via the national supervisory authority.

The banking system of a country that enters into close cooperation must of course undergo an extensive health check before the SSM takes on supervision - just as happens at present in the euro area.

Conclusion

Ladies and Gentlemen, let me draw your attention one final time to our vast construction project. It is almost finished.

Countless experts from the euro area have worked together on this project.

And here I am also talking in particular about my colleagues at the national supervisory authorities, from the Oesterreichische Nationalbank and the Finanzmarktaufsicht.

With incomparable effort, they have helped to shape the project at all levels by means of expert knowledge, years of experience and manpower: from many, many working groups to the numerous staff who have come to prepare the day-to-day running of the building and make sure it can function over the medium term.

They have all made an essential contribution to ensuring that, from the plans to the operational phase, it has always been possible to maintain the balance between the necessary ultimate responsibility at the central level and the legitimate interests of the euro area countries in both planning and implementation.

This will continue to be so in the future, as the 18 (soon 19) member countries with their national supervisory authorities will also be prominently represented in the Supervisory Board.

I have no doubt that our European supervisory project will be ready on time.

There are exactly 35 days to go till the start date, 4 November.

In Frankfurt we are currently working very hard on the start of regular supervisory operations at the ECB, as the responsibility for the supervision of around 4,700 credit institutions in the euro area will from that day on lie with us.

The staff of the SSM has largely been recruited.

A few interviews are still being held.

The way supervision will be carried out has been defined.

The division of labour between the national supervisory authorities and the ECB has been laid down. Internal procedures have been set out in the Supervisory Manual.

The part of the construction project covering significant credit institutions is virtually complete.

The Joint Supervisory Teams, which will supervise the 120 significant banking groups, have already formed and are getting up to speed on their banks.

In the part covering less significant institutions, our colleagues are currently gathering detailed information on the banking supervision systems and the population of other banks and their features in the euro area.

This part will also be ready to operate on 4 November.

Ladies and Gentlemen, I am convinced that only by working closely together and ensuring a clear division of labour between national supervisors and the ECB will we be able to fulfil our mandate to make the banking system of the euro area more robust.

The foundations of the SSM will in future surely be exposed sometimes to uneven stress in one place or another.

This is completely normal for a building that stands for many years.

As long as we do not forget the principles applied by the architects of the SSM, it will always be possible for the ECB and the national supervisory authorities to together regain the right balance.

This is the prerequisite for ensuring that the primary aim of the SSM, high-quality banking supervision in the euro area, is met in the long term.

Thank you for your attention.

Long-term challenges facing banks in Germany

Dinner speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Bundesbank's autumn conference "Achieving Sustainable Financial Stability", Berlin

1. Introduction

Ladies and gentlemen

It is a pleasure for me to welcome you to this year's Bundesbank autumn conference.

In my view, the topic of this conference is well chosen.

The crisis and the great uncertainties it has brought on have made the pursuit of financial stability all the more urgent.

For this reason I am delighted that so many of you have been able to accept the Bundesbank's invitation to discuss this sensitive issue.

This evening I would like to take a closer look, with you, at the long-term challenges facing German credit institutions.

With more than 1,800 institutions, the German financial system is the largest - in terms of sheer numbers - in the euro area.

This large number reflects a special feature of the German banking system, namely that it is built on three pillars.

Alongside the private banks, many regional savings banks and credit cooperatives are in operation.

In the crisis, these locally important institutions played a major part in stabilising the German economy, because they were less strongly affected by the financial crisis thanks to their traditional business model.

Nonetheless, all banks have felt the effects of a great loss of confidence since the financial crisis erupted in 2008 - they have lost the confidence of the general public, of trade and industry and of the interbank community.

There are two major reasons for this loss of confidence.

The first is uncertainty about how sound individual institutions actually are.

The second relates to wrong investment advice in connection with securitisation products and certificates.

More recently, confidence suffered again as information about banks' misconduct came to light - for example, the manipulation of reference rates such as Euribor and Libor or the legal violations that have often garnered so much attention from the media.

The financial crisis and the subsequent loss of confidence have given rise to a major reform of financial regulation.

Basel III is certainly the best known and most important of the measures designed to make banks more resilient by strengthening their capital and liquidity position.

And many banks have indeed strengthened their capital position significantly over the past years.

This elevated robustness is indispensable, as it was never possible at any point in the past to identify the specific causes of the next crisis in good time.

This means that, in future, institutions will also have to be prepared for hitherto unknown dangers, uncertainties we may not even know exist.

And here, a strong capital position is the best buffer against shocks, regardless of where they come from.

However, dealing with unknown dangers requires German banks to embrace a new risk culture.

The crisis made us painfully aware of just how far removed from a sound culture of risk the risk culture was at many banks in Germany.

2. Risk culture

One reason for an inadequate risk culture lies in the "too big to fail" problem, which was a central issue in the last crisis.

The failure of banks that are very large or strongly interconnected might endanger the whole financial system - the failure of Lehman Brothers in 2008 was a case in point.

Thus, in the eyes of the markets these banks enjoy an implicit state guarantee: in case of trouble, the state would feel compelled to step in and rescue the distressed bank.

Yet this implicit state guarantee creates flawed - and dangerous - incentives.

If a bank can be sure of state support when it gets into difficulties, it will no longer see risk and return as being two sides of the same coin.

Essentially, this means that profits from risky business operations remain with the bank, while the taxpayer is left to shoulder potential losses: this is an unjustifiable scenario.

For this reason, I believe that an important signal to the market and to banks is to develop mechanisms that allow even big banks to fail without destabilising the entire financial system.

The possibility of a market exit, which is fundamental to any market economy, must also exist for the banking sector.

The real threat of actually failing is in itself a strong incentive for banks to be more aware of risk in their actions.

The long-term goal, then, must be to put risk and return back onto the same page.

One important step towards that goal is the European resolution mechanism which will start in 2016.

This mechanism ensures that the owners and creditors of banks are the first in line when it comes to bearing losses.

Consequently, the taxpayer will be the last in line to foot the bill.

This realigns risks and rewards and will certainly have a fundamental and positive effect on the risk culture within banks.

Yet what is crucial here is not only that rules are in place for dealing with a distressed bank, but that banks don't get into financial dire straits in the first place.

Banks have to improve their risk culture regardless of the "too big to fail" problem.

At the spring meeting of the Financial Stability Board, recommendations for action were agreed on and subsequently announced.

According to the Financial Stability Board, the foundational elements of a sound risk culture are effective risk governance, an effective risk appetite framework and, in particular, the alignment of compensation with prudent risk taking.

Four practices may help in assessing the soundness of a risk culture.

- First, the tone from the top: the board and senior management are the starting point for setting the financial institution's core values and the expectations for its risk culture, and their behaviour must reflect the values being espoused.

- Second, accountability: employees must understand the institution's core values and its approach to risk. And they have to be aware that they are responsible for their actions and risk taking.

- Third, effective communication and challenge: a sound risk culture promotes an environment of open communication and effective challenge, within which decision-making processes encourage a range of views.

- Last but not least, incentives: performance and talent management encourage and reinforce maintenance of the financial institution's desired risk management behaviour.

This includes changing the banks' in-house incentive schemes.

One example here would be to cap bonus payments and link them to the long-term development of institutions' profits.

We must succeed in embedding awareness of sustainable business practices more firmly in the risk culture of banks.

3. Profitability

Of course, a new risk culture has its price, which will unquestionably also have a short-term impact on the banks' profitability.

What's more, the current low-interest-rate environment also remains a major challenge for the profitability of banks.

German savings banks and credit cooperatives in particular rely on net interest income as the most important earnings component.

Consequently, they expect a further decline in profitability in the current interest rate environment.

In addition, competitive pressure is high due to the sheer number of institutions in the marketplace, and this will no doubt increase as the integration of the banking market across Europe deepens.

Last but not least, the implementation of the new banking rules will come at a cost - to raise fresh capital, say, or to draw up recovery plans and build up a restructuring fund.

Against this backdrop, it is essential that German credit institutions recognise their weaknesses and counteract them at an early stage.

This could be achieved by boosting income in fee and commission business and by taking into consideration cost-cutting measures.

There is traditionally a strong branch network in Germany.

Streamlining this could reduce costs.

Mergers could also make sense for several credit institutions, with the focus in each case being on the sustainability of each business model.

4. Closing remarks

Ladies and gentlemen

In my speech, I have discussed three challenges that German banks currently face: regulatory reform, necessary changes in risk culture and low profitability.

Regulatory reform definitely comes at a cost for the banks.

However, when we talk about the cost of regulation for the banks, we also need to talk about the cost of crises for the general public.

Viewed from this perspective, I think the price we are paying for stricter regulation is entirely appropriate.

Even for the banks themselves, the rising outlay for regulatory matters is not only a cost factor.

They, too, benefit from a stable financial system.

The same is true of a change in risk culture.

There is evidence that institutions inadequately identified and managed not just their market and credit risks but their operational risks as well: it is therefore imperative that improvements be made.

Credit institutions have themselves already announced their intention to change their risk culture.

However, this fundamental decision is not one that should be merely voiced at the senior management level.

The banks must do more than simply talk the talk: their new values must be practised institution-wide by managers and employees alike.

In conclusion, each institution faces the major challenges of adjusting to new regulatory requirements and of improving its risk culture without completely losing sight of profitability, particularly as profitability is already challenged by the current environment of low interest rates and fierce competition in the German banking market.

However, I am confident that German credit institutions will succeed in overcoming the challenges ahead and in finding a healthy balance between risk and reward.

The first steps to achieving these goals have already been taken.

Thank you for your attention.

News Release - Financial Policy Committee statement from its policy meeting

The Chancellor of the Exchequer announced in June that HM Treasury wanted to grant the Bank of England's Financial Policy Committee (FPC) additional powers to guard against financial stability risks from the housing market before the end of this Parliament.

The FPC therefore discussed this at its meeting on 26 September and is announcing today its recommendation to HM Treasury on the form of these powers:

The FPC recommends that HM Treasury exercise its statutory power to enable the FPC to direct, if necessary to protect and enhance financial stability, the PRA and FCA to require regulated lenders to place limits on residential mortgage lending, both owner-occupied and buy-to-let, by reference to:

a) Loan-to-Value Ratios;

b) Debt-to-Income Ratios, including Interest Coverage Ratios in respect of buy-to-let lending.

These instruments would sit alongside the FPC's power of Direction on sectoral capital requirements and its responsibility for setting the countercyclical capital buffer (CCB) rate, and complement the FPC's existing powers of Recommendation.

The FPC judges that, taken together, these instruments are necessary, and should be sufficient, to tackle risks to financial stability that could emerge from the housing market in the future, rather than indicating likely FPC policy decisions in the short term.

The FPC is publishing today a separate Statement that sets out its rationale and supporting material for this recommendation.

The FPC intends to issue a draft Policy Statement to inform Parliamentary debate.

If the FPC is granted these powers, it will publish a final Policy Statement that outlines its approach to using them, including the indicators that it will monitor regularly.

The FPC is also publishing a letter to the Chancellor giving its first annual assessment of the impact on financial stability of the Help to Buy:

Mortgage Guarantee Scheme, including, as requested, whether the parameters of the scheme – the house price cap for eligibility in the scheme and the fee charged to lenders – remain appropriate.

The Committee does not see a case for changing the fee or the house price cap on financial stability grounds at this point.

In forming this assessment, the Committee was notified by HM Treasury that the fees for the scheme would remain the same for 2015, with prices set on an actuarially fair basis and according to State Aid rules.

The Committee will continue to monitor the impact of the scheme as part of its regular assessment of risks to financial stability and can make recommendations on it at any time.

The FPC also reviewed its assessment of the outlook for financial stability and progress against its existing policy recommendations.

Since the Committee met in June, geopolitical and event risks appear more marked.

In the United Kingdom, there had been intense focus on the referendum on Scottish independence.

In the run-up to that referendum, the FPC was briefed on the financial stability risks associated with possible outcomes and on the Bank's contingency planning to mitigate those risks.

Global economic prospects remain modest. Growth in the euro area in particular had disappointed in the first half of 2014 and inflation fell further below target.

In this context, monetary policy has remained highly accommodative internationally.

Markets appear to expect a gradual exit from low rates in the United Kingdom and the United States, while the ECB has cut its benchmark interest rate and announced a package of new stimulus measures.

In emerging markets, growth forecasts are also slightly lower, with concerns about the sustainability of credit growth and property markets in China persisting.

Financial markets have remained remarkably resilient to geopolitical and event risk with continuing signs of yield-seeking behaviour.

There were some falls in risky asset prices internationally during the summer and a pick-up in market volatility, but these proved largely temporary.

A larger shock could still be amplified through the financial system, particularly if the apparent narrowing of the compensation required by market participants for liquidity risk were to unwind.

This risk is heightened by what appears to be a continued structural reduction in liquidity in some financial markets.

The Committee is considering the resilience of market liquidity as part of its medium-term priority on supporting diverse and resilient market-based finance.

In the United Kingdom, economic growth has been robust and broadly based.

While the housing market remains a source of risk to financial stability, activity appears to have eased slightly and the MPC's latest projections are consistent with the rate of increase in house prices moderating earlier than previously expected.

UK commercial property markets have been recovering rapidly, supported by buoyant conditions for new lending.

The major UK banks remain on a path of gradually improving resilience, with reduced leverage and increased capital ratios and lower reliance on wholesale funding since the crisis.

But uncertainty remains over potential further global conduct-related actions.

The results of the 2014 stress tests will give a fuller view of the major UK banks' capital resilience.

In light of its assessment of the outlook for financial stability, the FPC decided to keep the CCB rate for UK exposures at 0%.

It will expect to reciprocate foreign CCB rates, in order to support the resilience of the global financial system.

In that context, the FPC decided also to recognise the 1% CCB rates set recently by the Norwegian and Swedish authorities.

These would apply to UK regulated firms with relevant exposures to these countries from 3 October 2015.

With regard to the FPC's existing recommendations:

- The FPC judges that its June recommendation to lenders on the interest rate stress test to use when assessing affordability in mortgage lending is implemented, by virtue of existing FCA rules (MCOB 11.6.18(2)).

The FCA will continue to monitor that mortgage lenders are having regard to the recommendation when carrying out the interest rate stress test, as part of supervision. At the time of the FPC's meeting, the PRA Board was due to finalise the rule that would put into force the FPC's recommendation on a limit on loan-to-income ratios in mortgage lending.

The PRA Board subsequently confirmed this rule at its meeting on 30 September.

The FCA is implementing the measure for affected FCA-regulated firms via general guidance.

- The FPC judges that the PRA has implemented its recommendations to work with the banking industry to ensure greater consistency and comparability of Pillar 3 disclosures of major UK banks and building societies, and to ensure that all major UK banks and building societies comply fully with the October 2012 recommendations of the Enhanced Disclosure Task Force upon publication of 2013 annual reports.

- The FPC also judges that it is now appropriate to publish a recommendation that it had initially made privately in June 2013 to the Bank of England and the FCA, that they should promote the development of contingency plans in the event that Libor or other interest-rate benchmark quotes became unavailable.

At that stage it had decided not to publish the recommendation, as permitted under Section 9U(8)(b) of the Bank of England Act 1998, because of the risk of precipitating the unavailability of benchmark quotes that the recommendation was seeking to avoid.

The FPC closed the recommendation in September 2013, because interest-rate benchmark contingency planning was then taking place under the auspices of the Financial Stability Board.

On 22 July 2014, the FSB published its report on Reforming Major Interest Rate Benchmarks, which includes details on contingency planning; the FPC judges that publication of its recommendation is therefore no longer against the public interest.

- The FPC noted that progress was under way on its existing recommendations on stress testing and resilience to cyber attack and it would review these in more detail at future meetings.

The Committee's public consultation on the Leverage Review closed on 12 September.

A total of 26 responses were received.

The Committee noted that a common theme in the feedback was around the need for guidance over how the proposed framework would be calibrated.

In the light of that feedback and to support HM Treasury in its consultation on, and impact assessment of, the Committee's proposals, the Committee decided to bring forward its view on the appropriate calibration of the leverage ratio framework.

That view will be recorded in its final proposals for the leverage ratio framework, which will be published at the end of October.

The Record of the Committee's meeting will be published on 10 October.

Review of the Principles for the Sound Management of Operational Risk

1. Executive summary

In June 2011 the Basel Committee on Banking Supervision published its "Principles for the Sound Management of Operational Risk" ("the Principles") to provide guidance to banks on the management of operational risk.

The eleven principles incorporate the lessons from the financial crisis and the evolution of sound practice for management of operational risk.

The Principles cover governance, the risk management environment and the role of disclosure, and address the three lines of defence (business line management, an independent corporate operational risk management function and an independent review).

In light of the significant number of recent operational risk-related losses incurred by banks, and consistent with the Committee's greater focus on monitoring the implementation of its standards and guidance, earlier this year the Basel Committee conducted a review of the implementation of its Principles.

The review involved 60 systemically important banks in 20 jurisdictions and covered all 11 principles with a specific focus on the guidance related to the three lines of defence.

The exercise was designed as a questionnaire by which banks self-assessed their implementation of the Principles.
While it was conducted under the overall supervision of the Basel Committee and the respective supervisory authorities, the review did not involve an onsite validation of the banks' responses.
The objectives of the exercise were to

(i) establish the extent to which banks have implemented the Principles,

(ii) identify significant gaps in their implementation and

(iii) highlight emerging and noteworthy operational risk management practices at banks that are not currently addressed by the Principles.

Key findings and observations

Overall, banks have made insufficient progress in implementing the Principles originally introduced in 2003 and revised in 2011.

Many banks are still in the process of implementing various principles. Systemically important banks (SIBs) have implemented the Principles and the operational risk management tools to varying degrees.

Historically, implementation of the Principles was strongly aligned with the Basel Framework's approaches to calculating operational risk capital requirements such as The Standardised Approach (TSA) and the Advanced Measurement Approach (AMA).

Banks applying these more advanced approaches are expected to have more advanced operational risk management frameworks and implement to a greater degree the operational risk management tools, which include risk and control self-assessments (RCSAs), internal loss data collection, scenario analysis, external data collection and analysis, key risk indicators (KRIs)/key performance indicators (KPIs), change management and comparative analysis.

Some SIBs, however, have yet to implement all of the Principles and do not deploy the full range of operational risk management tools.

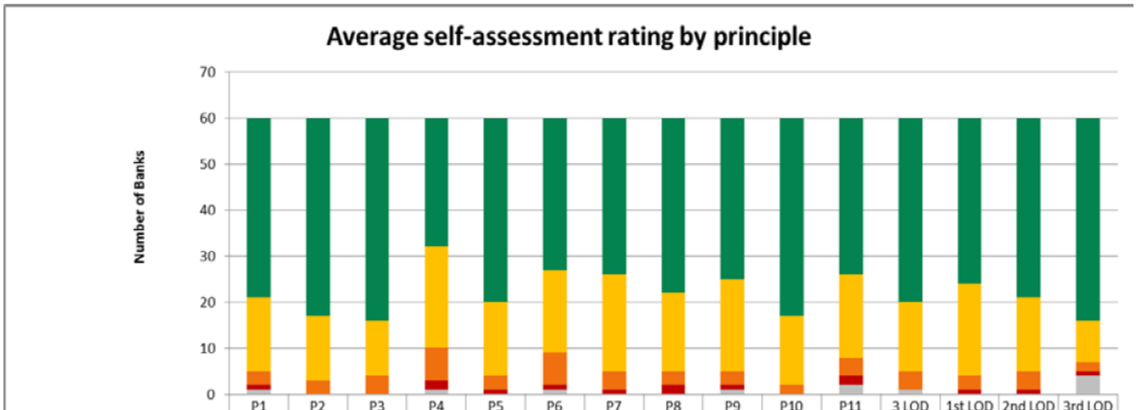
This may be because some of the banks are not subject to the most advanced approaches to operational risk and the associated higher expectations for managing the risk.

Therefore, these banks may not be adequately identifying and managing their operational risk exposures.

Methods for identifying and managing operational risk should be seen as complementary to the calculation of operational risk capital requirements, rather than as a consequence of that activity.

Aligning the implementation of the risk management principles with the risk profile and systemic importance of banks, rather than the approaches selected to calculate operational risk capital requirements, is also be consistent with the objective of more intensive and effective supervision of systemically important banks.

The following chart summarises the average bank ratings for each of the Principles and the three lines of defence.



	P1	P2	P3	P4	P5	P6	P7	P8	P9	P10	P11	3 LOD	1st LOD	2nd LOD	3rd LOD
Fully complied with	39	43	44	28	40	33	34	38	35	43	34	40	36	39	44
Largely complied with	16	14	12	22	16	18	21	17	20	15	18	15	20	16	9
Materially not complied with	3	3	4	7	3	7	4	3	3	2	4	4	3	4	2
Not been implemented	1	0	0	2	1	1	1	2	1	0	2	0	1	1	1
Not applicable	1	0	0	1	0	1	0	0	1	0	2	1	0	0	4
Average	3.50	3.64	3.65	3.25	3.59	3.32	3.45	3.54	3.50	3.68	3.37	3.52	3.55	3.56	3.47

This review has identified various challenges and themes within each of the principles.

Four principles have been identified as among the least thoroughly implemented by banks including

(i) operational risk identification and assessment,

(ii) change management,

(iii) operational risk appetite and tolerance, and

(iv) disclosure.

In addition, weaknesses have been observed in the implementation of the overarching principle of the three lines of defence.

The following section summarises the challenges and themes related to these principles.

Fundamental principles of operational risk management

Operational risk identification and assessment (Principle 6)

Overall, while banks have implemented some of the operational risk identification and assessment tools, others are not fully implemented or are not being effectively used for risk management purposes.

Some banks indicated that the tools that had been implemented were largely used for risk measurement purposes (ie capital measurement and allocation), while others indicated that tools had not been fully implemented because they were not deemed necessary for risk measurement purposes.

In addition, a wide range of practice was reported regarding the implementation of many of these tools.

For instance, while many banks have implemented distinct, multi-tiered operational risk management tools (ie RCSAs, scenario analysis, business process mapping), other banks noted that they have chosen to implement one tool that would serve the purpose of two or possibly three tools together (ie a scenario-based RCSA, a process-based RCSA etc).

Furthermore, at some banks, considerable management effort will be required to ensure the bank-wide implementation of certain tools.

These include key risk and performance indicators; external data collection and analysis; and comparative analysis as well as the creation and monitoring of action plans generated through the use of the operational risk management tools.

Change management (Principle 7)

Overall, there are many aspects of change management that have not been fully implemented by many of the banks.

The change management principle had one of the lower average ratings assigned, indicating that banks are continuing to implement and enhance their existing change management programmes (eg new products and initiatives).

Only about two thirds of the banks have fully implemented risk and control assessments within the change management process for new products and initiatives.

While the Principles define changes to include new products, activities, processes and systems, there is a wide range of practice as it relates to the policy framework for change management processes.

For instance, a few banks said that their governance framework did not apply to all types of change such as outsourcing.

Many banks also noted that the operational risk taxonomy is either not applied, or not consistently applied, to various changes including new products, activities, processes and systems.

Alignment with the bank's taxonomy would allow for integration and aggregation of results with the overall risk profile.

Several banks noted that the roles and responsibilities relating to change management were included within either the bank's operational risk management framework or underlying change management-related policies.

Many banks also noted the involvement of several control groups within the second line of defence review of risk and control assessments, such as compliance, legal, business continuity, technology, and other risk management groups.

However, a number of banks continued to state that the second line of defence responsibilities were not yet fully implemented as they relate to change management.

In addition, a small number of banks noted that these other control groups were primarily responsible for performing the risk and control assessments, which is not fully aligned with the concept of the three lines of defence.

Some banks also noted that the corporate operational risk function (CORF) was only involved in the process through membership in the approval and oversight committee.

Participation in a committee may not fully provide for the opportunity to provide an effective challenge to the first line of defence's risk and control assessment.

In addition, many banks noted an absence of, or a partially implemented, process for monitoring of risks following the approval of the initiative, as well as an absence of a formal post- implementation review process.

Operational risk appetite and tolerance (Principle 4)

Many banks generally indicated that establishing a risk appetite and tolerance statement was more challenging for operational risk than for other risk categories, such as credit risk and market risk, and attributed this to the nature and pervasiveness of operational risk.

For those banks that have established an operational risk appetite and tolerance statement, a commonly observed practice was the inclusion of a metric such as operational losses as a percentage of gross revenue.

However, these metrics tended to be backward- rather than forward-looking.

As a result, many banks indicated that work is under way to enhance the existing operational risk appetite and tolerance statement.

Role of disclosure (Principle 11)

Most banks said that their general quality of operational risk disclosure is fully compliant, pointing to the existence of a specific section for operational risk in the annual report or individually developed disclosure templates under the Basel Framework's Pillar 3 requirement.

However, they do not disclose sensitive information relating to control gaps or issues, suggesting that these disclosures tend to be primarily high-level statements.

The relative lack of information on the operational risk profile and how banks manage their operational risk may be attributable to inadequate implementation of a disclosure policy that is subject to approval and oversight by the board.

Three lines of defence

Most banks reported that they comply fully with the "three lines of defence" principle.

Judging from the comments submitted, however, it is apparent that a range of practice exists relating to the implementation of the three lines of defence.

In a few cases, banks inappropriately classified responsibilities across each of the three lines of defence (eg they assigned various business line responsibilities to the second line of defence).

Some banks also noted more significant challenges in the consistency of the application and their ability to substantiate the independent review of the operational risk management tools used by the first line of defence.

A few banks noted insufficient resources within the CORF.

In addition, a large number of banks have yet to fully develop a quality assurance programme that is applicable within the second line of defence.

Most banks indicated that responsibilities relating to the third line of defence were fulfilled.

They noted that those performing review and challenge of the design and effectiveness of the bank's operational risk management controls, processes and systems are not involved in the development, implementation and operation of the operational risk management framework.

Most banks also said that internal audit coverage of the framework is adequate.

They added that the review of both the first and second lines of defence is sufficient and commensurate with other risk management functions where they follow a risk-based approach when determining the frequency and scope of the audit.

However, almost a third of the banks noted that further enhancements were needed or planned to ensure full compliance and, as outlined in other sections of this report, some banks noted that coverage was limited to the operational risk model and its inputs, rather than the implementation of the overall operational risk management framework (ORMF).

Furthermore, most banks indicated that internal audit has sufficient resources to carry out its responsibilities as a third line of defence.

However, a few banks noted that their third line of defence responsibilities needed improvement in terms of definition, execution and monitoring, and that staffing within internal audit was insufficient.

Many banks also noted that they are still in the process of implementing a more refined approach to assigning specific responsibilities to the three lines of defence.

Recommendations

Failure to fully implement appropriate operational risk identification and management practices may result in direct and material financial losses, or reputational and consequential losses, and could lead to a systemic impact on other banks, customers, counterparties and the financial system.

As illustrated throughout this report, banks noted that they are at varying stages of implementation of each of the Principles.

The review also highlighted several principles where, overall, banks had not adequately implemented and addressed the related risk management practices.

In particular, banks should:

- improve the implementation of each of the operational risk identification and assessment tools, including risk and control self-assessments, key risk indicators, external loss data, business process mapping, comparative analysis, and the monitoring of action plans generated from various operational risk management tools;

- enhance the implementation of change management programmes and processes and ensure their effective monitoring;

- strengthen the implementation of the three-lines of defence, especially by refining the assignment of roles and responsibilities; and

- improve board and senior management oversight; articulation of operational risk appetite and tolerance statements; and risk disclosures.

2. Introduction

The Principles for the Sound Management of Operational Risk ("the Principles"), as updated and published in June 2011, cover

(i) fundamental principles of operational risk management,

(ii) governance, and

(iii) the risk management environment.

In December 2012, the BCBS's Working Group on Operational Risk (WGOR) established a work stream to undertake a review of the implementation of the Principles. Conducted via a questionnaire, the review aimed to:

• identify and understand the degree to which banks have implemented the Principles;

• identify common significant gaps at banks related to the implementation of the Principles; and

• identify emerging and noteworthy practices in operational risk management that are used by banks but which are not currently addressed by the Principles.

3. Findings and observations

A questionnaire was used to solicit self-assessments from participating banks. The questionnaire contained 180 questions and was completed by 60 systemically important banks across 20 jurisdictions.

The questionnaire covered all 11 Principles as well as the on the overarching guidance related to the three lines of defence.

Banks were asked to self-assess and rate their operational risk management practices on a rating scale of "1" to "4" or "N/A".

The four ratings were defined as follows:

1 - Principle has not been implemented

2 - Principle is materially not complied with

3 - Principle is largely complied with

4 - Principle is fully complied with

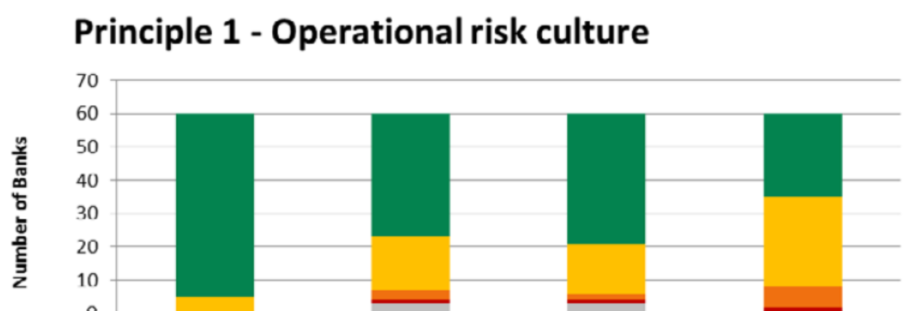
For further information on the guidance given to banks in completing the self-assessment ratings, see Appendix II. For a full list of Principles and criteria that were surveyed, see Appendix III.

Principle 1: Operational risk culture

The board of directors should take the lead in establishing a strong risk management culture.

The board of directors and senior management should establish a corporate culture that is guided by strong risk management and that supports and provides appropriate standards and incentives for professional and responsible behaviour.

In this regard, it is the responsibility of the board of directors to ensure that a strong operational risk management culture exists throughout the whole organisation.



	R1	R2	R3	R4
Fully complied with	55	37	39	25
Largely complied with	5	16	15	27
Materially not complied with	0	3	2	6
Not been implemented	0	1	1	2
Not applicable	0	3	3	0
Average	3.92	3.38	3.43	3.25

Ratings

The banks were asked to rate and describe to what extent the following elements of the Principles had been implemented:

(a) a code of conduct or ethics policy (R1);

(b) alignment of compensation policies with their risk appetite and tolerance etc (R2);

(c) compensation policies that balance risk and reward (R3); and

(d) availability of operational risk training throughout the organisation (R4).

As reflected in the chart above, overall, most banks indicated that a strong operational risk management culture had been implemented throughout their organisations and that the board of directors and senior management had established a culture that provides for appropriate incentives for professional and responsible behaviour.

Almost all banks reported that they have fully implemented a code of conduct or ethics policy that

(i) sets clear expectations for integrity and ethical values of the highest standard,

(ii) identifies business practices and conflicts, and (iii) is in compliance with all applicable laws, rules and regulations (R1).

Noteworthy practices include ensuring that the code of conduct or ethics policy

(i) applies to all the bank's staff including the board of directors,

(ii) is regularly reviewed and attested to by employees,

(iii) is regularly approved by the board of directors, and

(iv) is publicly available on the bank's website.

Other noteworthy practices include the establishment of a separate code of conduct specifically designed for certain roles (eg treasury dealers, senior management), a whistle-blower programme and a senior ethics committee.

Many banks noted that compensation policies appropriately balance risk and reward and are well aligned with the bank's long-term strategic direction, financial goals and overall safety and soundness (R3).

Some banks indicated that their compensation policy is aligned with the FSB Principles for Sound Compensation Practices; they employ appropriate deferral mechanisms and claw-backs and balance the proportion of fixed and variable compensation tied to multiple factors, often including corporate performance, business performance and individual performance.

However, few banks indicated that work is under way to better align the compensation policies with the statement of risk appetite and tolerance.

Noteworthy practices include remuneration linked to risk-adjusted indicators.

Regarding the establishment of operational risk training at all levels throughout the organisation (R4), most banks indicated that some form of operational risk training has been established.

For example, some banks have established online operational risk training modules focused on various aspects of operational risk, such as "Operational risk 101" and on specific topics such as business continuity, information security or financial crime.

Many banks have plans to enhance existing operational risk training, and several banks noted that plans are also in place to enhance the operational risk training and awareness for the board of directors.

Noteworthy practices include the establishment of operational risk awareness for all employees, more advanced training on operational risk identification and assessment tools, and processes and policies for individuals with operational risk responsibilities.

Other noteworthy practices include customised and mandatory operational risk training for many roles (ie business unit operations, supervisory levels, senior management and the board of directors) and strong internal monitoring of training practices in relation to requirements.

Overall, banks are encouraged to:

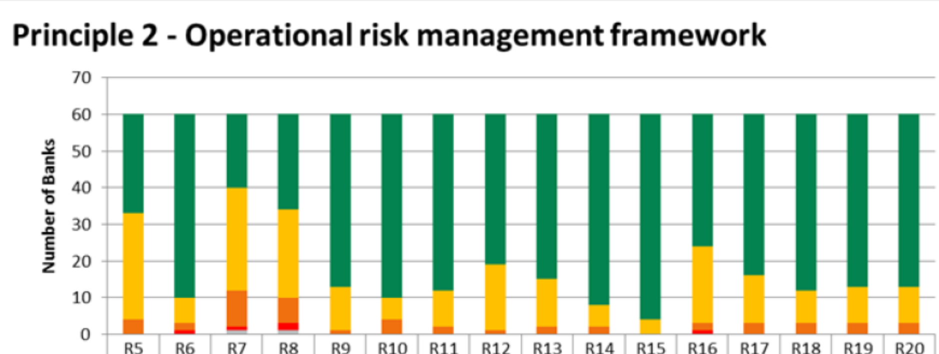
- continue to make progress in aligning compensation policies with the operational risk appetite and tolerance statement; and

- develop further and implement their operational risk training and awareness programmes.

Principle 2: Operational risk management framework

Banks should develop, implement and maintain a framework that is fully integrated into the bank's overall risk management processes.

The framework for operational risk management chosen by an individual bank will depend on a range of factors, including its nature, size, complexity and risk profile.



	R5	R6	R7	R8	R9	R10	R11	R12	R13	R14	R15	R16	R17	R18	R19	R20
Fully complied with	27	50	20	26	47	50	48	41	45	52	56	36	44	48	47	47
Largely complied with	29	7	28	24	12	6	10	18	13	6	4	21	13	9	10	10
Materially not complied with	4	2	10	7	1	4	2	1	2	2	0	2	3	3	3	3
Not been implemented	0	1	1	2	0	0	0	0	0	0	0	1	0	0	0	0
Not applicable	0	0	1	1	0	0	0	0	0	0	0	0	0	0	0	0
Average	3.38	3.77	3.08	3.20	3.77	3.77	3.77	3.67	3.72	3.83	3.93	3.53	3.68	3.75	3.73	3.73

Ratings

The banks were asked to rate and describe their current degree of implementation for many aspects related to their operational risk management framework (ORMF), including the following:

(a) the integration of the ORMF into the overall risk management processes (R5);

(b) the application of the ORMF to all the bank's material operating groups and entities (R17);

(c) the establishment of an ORMF that includes various items such as the governance structures used to manage operational risk (R7), the use of operational risk and identification and assessment tools (R8), and the review and approval requirements of the framework itself (R6, R14, R16);

(d) the establishment of a common taxonomy of operational risk terms (R12) which should include definitions of operational risk and operational risk event types (R15); and

(e) the establishment of operational risk reporting and management information system (MIS) requirements (R11).

Regarding banks' views on the integration of their ORMFs into their overall risk management processes (R5), this requirement received one of the lowest average ratings within Principle 2.

Many banks noted that reporting by the operational risk management group to the chief risk officer is consistent with other risk management groups, and that operational risk information is reported to the same officers who receive the other risk management reports.

At the same time, however, many banks noted that there is further opportunity to integrate the operational risk assessment programme into the bank's strategic decision-making process.

In addition, some banks noted the need to further strengthen the operational risk assessment process within the new product development and new initiative processes.

A bank's ORMF is also expected to apply to all of a bank's material operating groups and entities, including subsidiaries, joint ventures and geographic regions (R17).

While overall the banks rated themselves strongly on this requirement, a few banks are still in the process of rolling out the framework to some small subsidiaries.

Regarding the application of the ORMF to joint ventures, challenges were noted relating to the concept of "controlling interest".

While one bank noted that the ORMF is applied to all entities with a common brand name, logo or equity investment of 30% or more, other banks apply the ORMF only where there is a greater than 50% ownership in the joint venture.

Many banks noted that joint ventures are not controlled by the bank and therefore these entities are governed by a shareholder agreement that sets out its own governance programme including shareholder membership on the board, as well as agreements to share the bank's risk policies and guidelines for the joint venture to consider.

Regarding the establishment of an ORMF that identifies various aspects such as the governance structures (R7), operational risk identification and assessment tools (R8), many banks noted that these were not adequately identified within their ORMF as these items received the lowest ratings within Principle 2.

In addition, while some banks were quick to update and align their ORMFs following the June 2011 release of the revised BCBS Principles, many banks were slow to respond and only recently updated their ORMFs to reflect the updated guidance.

The banks also noted that, in general, their ORMF established a common taxonomy of operational risk terms and included definitions of operational risk and operational risk event types.

While some banks referenced the use of the Basel framework's operational loss event categories, other banks noted the development of a complementary operational risk taxonomy that is causal-focused, and not loss-focused.

Responding banks were of the view that the frameworks had adequately established these taxonomies, though some noted that further work is needed to ensure the consistent implementation of the risk taxonomies across all business lines and operational risk tools, and these banks are focusing on the establishment of a quality assurance programme.

Many banks also noted that the consistent use of an operational risk taxonomy across the bank and within the tools would allow for better aggregation of risks and issues for the purposes of updating their operational risk profiles, and for senior management and board reporting.

Noteworthy practices include the creation of an operational risk dictionary that includes definitions and examples of various operational risks in the bank's taxonomy, as well as guidance related to the classification of each of the operational risks within the taxonomy, to ensure consistent identification and classification across the bank.

An additional noteworthy practice was the establishment of a control library, which inventories all the controls within the bank and each of its business lines.

One bank also noted that its definition of operational risk events extends beyond direct financial losses, and includes indirect losses such as forgone revenue and lost business, and overall reputational damage due to an operational risk event.

Many banks noted that their ORMFs adequately established operational risk reporting requirements (R11), and pointed to the inclusion of the nature and frequency of reporting requirements for operational risk management.

In addition, many banks also noted the existence of a central operational risk system and data repository that allows for the central capture, aggregation and reporting of key operational risk data.

This includes operational losses, operational risk assessments, control deficiencies and key risk indicators.

However, some banks are currently self-assessing their operational risk practices against the Basel Committee's "Principles for Effective Risk Data Aggregation and Risk Reporting" guidance, which was published in January 2013.

Scope exists to enhance current practice as it relates to completeness and timeliness of data, as well as to enhance the current operational risk data reconciliation processes and the flexibility of operational risk reporting through improved ad hoc reporting.

Overall, banks are encouraged to:

- further develop the integration of the operational risk management programme into the bank's strategic decision-making process;

- ensure that the ORMF or other relevant policy requires a robust operational risk assessment process within the bank's new product and new initiative approval processes;

- ensure that the ORMF specifies the use of all implemented operational risk identification and assessment tools;

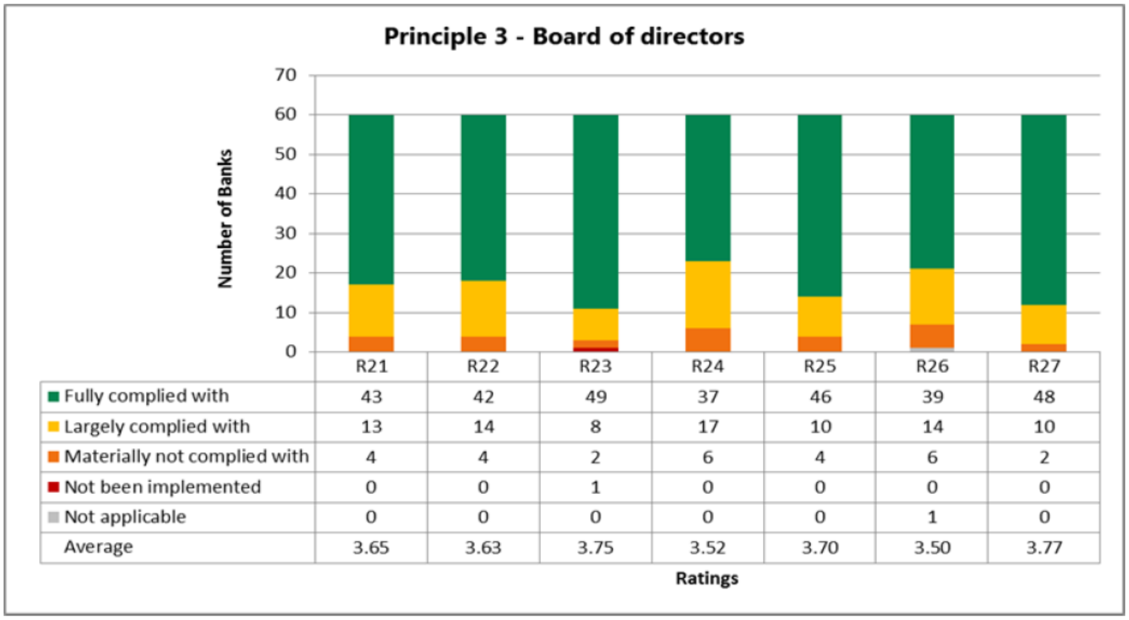
- ensure that the ORMF requires the use of the bank's operational risk taxonomy in all operational risk tools to allow for the aggregation and reporting of operational risks and control issues; and

- develop a quality assurance programme to ensure that the independent challenge and review applied by the second line of defence results in consistent risk and control assessments.

Principle 3: Board of directors

The board of directors should establish, approve and periodically review the framework.

The board of directors should oversee senior management to ensure that the policies, processes and systems are implemented effectively at all decision levels.



	R21	R22	R23	R24	R25	R26	R27
Fully complied with	43	42	49	37	46	39	48
Largely complied with	13	14	8	17	10	14	10
Materially not complied with	4	4	2	6	4	6	2
Not been implemented	0	0	1	0	0	0	0
Not applicable	0	0	0	0	0	1	0
Average	3.65	3.63	3.75	3.52	3.70	3.50	3.77

The banks were asked to rate and describe their current degree of implementation for a variety of board-related elements, including that the board:

(a) establishes a management culture, and supporting processes, and develops oversight of control environments (R21, R22);

(b) regularly reviews and approves the ORMF (R23, R24); and

(c) ensures the ORMF is subject to independent review and best practice (R25, R26).

As indicated in the table above, most banks said that the board was very active in establishing a strong risk management culture, and in overseeing the bank's control environments (R21, R22).

Common practice includes discussion and review of operational risk management reporting at the board level, and in board subcommittees mandated with more specific risk management oversight responsibilities.

Noteworthy practices include

(i) the board regularly challenges senior management on the design and effectiveness of the bank's operational risk management framework,

(ii) the board reviews and approves an operational risk management strategy that sets forth the long-term vision for the programme and the initiatives planned to support implementation, and

(iii) the establishment of a formal communication strategy, whereby senior management underlines the importance of strong risk management practices through a variety of forums such as employee communications and training sessions.

The topic of risk culture is receiving more attention from banks and many noted that they will monitor developments and will look to implement any resulting supervisory guidance.

Regarding the regular review and approval of the ORMF (R23, R24), most banks rated practices as either compliant or largely compliant. Many banks said that the board or a subcommittee (ie the risk or audit committee) was responsible for regularly reviewing and approving the ORMF.

However, a range of practice was noted as a few banks indicated that their board was not responsible for reviewing or approving risk management policies, but rather that these activities were delegated to senior management.

The banks explained this variation in practice by pointing to differences in their local legal environment and in supervisory guidance or expectations.

While most banks noted that such review and approval occurred at least annually or more frequently if there was a material change in risk profile, some banks noted that review and approval occurred less frequently (ie every two to three years), and one bank noted its review was performed once every five years.

As evident in the chart above, the banks also rated highly the board's role in ensuring the ORMF is subject to independent review and best practice (R25, R26).

Most said that this role was accomplished through the board's regular review of risk management reporting and internal audit reporting which included approval of the internal audit plan and review of ORMF audit reports.

A common practice also noted by the banks was the participation by employees in industry working groups and conferences to remain current on leading practices.

However, as it relates to the board ensuring that bank adopts best practices, only a small number said that the board had commissioned an external third party to review the design and effectiveness of the ORMF.

There were also a few banks that noted that internal audits of the ORMF were infrequent (ie between three and five years). In addition, a few banks said that the focus of internal audit's ORMF reviews were on the operational risk capital model, rather than a full implementation of the framework.

A noteworthy practice identified was the inclusion of ORMF reviews within business unit audits, to complement the overall audit of the ORMF.

Overall, banks are encouraged to:

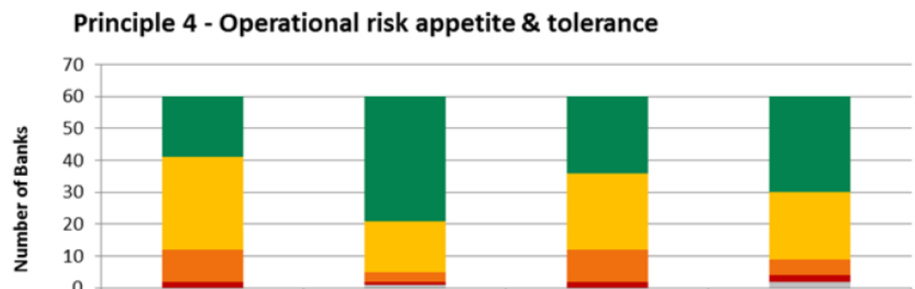
- ensure the scope of internal audit is on the full implementation and execution of the framework, rather than being limited to the operational risk capital model;

- ensure the scope of internal audit includes review of the effective implementation and execution of the ORMF at the business unit or legal entity levels, to complement the overall audit of the ORMF; and
- consider periodically engaging a benchmarking analysis of the bank's operational risk management framework with the assistance of

independent external advisors, as part of the regular assessment of the ORMF's design and effectiveness.

Principle 4: Operational risk appetite and tolerance

The board of directors should approve and review a risk appetite and tolerance statement for operational risk that articulates the nature, types, and levels of operational risk that the bank is willing to assume.



	R28	R29	R30	R31
Fully complied with	19	39	24	30
Largely complied with	29	16	24	21
Materially not complied with	10	3	10	5
Not been implemented	2	1	2	2
Not applicable	0	1	0	2
Average	3.08	3.52	3.17	3.25

Ratings

The banks were asked to rate and describe to what extent they have implemented the following elements related to operational risk appetite and tolerance:

(a) the risk appetite and tolerance articulates the types and levels of operational risk the bank is willing to assume (R28);

(b) the board approves the risk appetite and tolerance (R29);

(c) the board reviews the appropriateness of limits, considering many factors (R30); and

(d) the board monitors management's adherence to the operational risk appetite and tolerance (R31).

As reflected in the chart above, some banks said that they have established an operational risk appetite and tolerance statement that is reviewed regularly and approved by the board of directors or a delegated authority, while others noted that this is currently under development.

Many banks indicated that establishing a risk appetite and tolerance statement was more challenging for operational risk than for other risk categories such as credit risk and market risk, and attributed this to the nature and pervasiveness of operational risk.

As a result, many banks indicated that work is under way to enhance the existing operational risk appetite and tolerance statement.

For those banks that have established an operational risk appetite and tolerance statement, a commonly observed practice was the inclusion of a metric such as operational losses as a percentage of gross revenue.

However, these metrics tended to be backward- rather than forward-looking.

Noteworthy practices include defining operational risk appetite and tolerance at both a divisional and a taxonomy level, utilising both quantitative and qualitative components, and setting limits based on established key risk indicators such as loss metrics, deficiencies, events and residual risk assessments from operational risk identification and assessment.

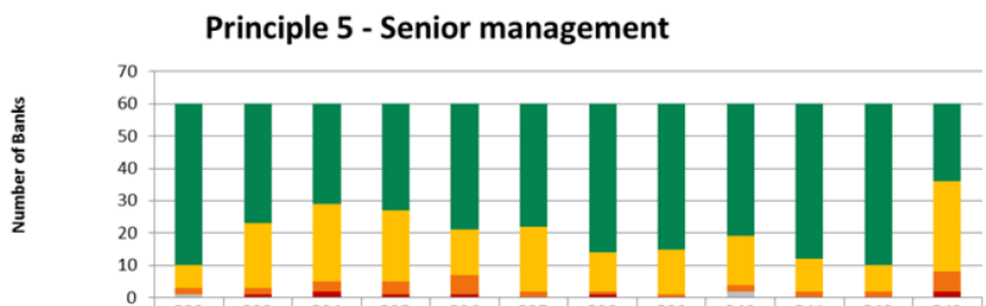
Overall, banks are encouraged to:

- **continue their work to further articulate and implement enhanced and forward-looking operational risk appetite and tolerance statements.**

Principle 5: Senior management

Senior management should develop for approval by the board of directors a clear, effective and robust governance structure with well defined, transparent and consistent lines of responsibility.

Senior management is responsible for consistently implementing and maintaining throughout the organisation policies, processes and systems for managing operational risk in all the bank's material products, activities, processes and systems consistent with the risk appetite and tolerance.



	R32	R33	R34	R35	R36	R37	R38	R39	R40	R41	R42	R43
Fully complied with	50	37	31	33	39	38	46	45	41	48	50	24
Largely complied with	7	20	24	22	14	20	12	14	15	10	8	28
Materially not complied with	2	2	3	4	6	2	1	1	2	2	2	6
Not been implemented	0	1	2	1	1	0	1	0	0	0	0	2
Not applicable	1	0	0	0	0	0	0	0	2	0	0	0
Average	3.75	3.55	3.40	3.45	3.52	3.60	3.72	3.73	3.55	3.77	3.80	3.23

The banks were asked to rate and describe the extent to which they have implemented the following elements of Principle 5:

(a) senior management establishes and supports an appropriate operational risk governance structure (ie governance structures, lines of responsibility, sufficient corporate operational risk function (CORF) stature and an operational risk committee) (R32, R36, R39);

(b) senior management ensures effective development and implementation of the ORMF and other operational risk policies through the recruitment of experienced and technical staff, ensuring appropriate level of resources and operational risk training, and effective communication and coordination of risk management responsibilities (R34, R35, R37, R43);

(c) senior management ensures effective implementation of challenge mechanisms, issue resolution processes and the three lines of defence

roles and responsibilities (ie business line management, CORF and internal audit) (R33, R38); and

(d) senior management establishes an operational risk committee that is functioning effectively (ie receives regular inputs from country, business or functional area, meets at appropriate frequencies with adequate time and resources to permit productive discussion and decision- making, and maintains records of committee operations that allow for review and evaluation of committee effectiveness) (R40, R41, R42).

Almost all banks reported having an independent and dedicated CORF to oversee the implementation of the bank's ORMF and also an internal audit group that assumed the responsibilities of the third line of defence.

In most cases, the CORF is responsible for reporting all operational risk-related matters in the bank to the appropriate senior management /committees.

The CORF is also typically staffed with tenured individuals with the appropriate seniority and experience and the title, stature and compensation of operational risk staff is commensurate with that of other risk functions.

Most banks also reported having an overall ORMF, which was supported by specific policies (ie loss data collection, risk and control self-assessment (RCSA), key risk indicators (KRI), loss modelling, scenario analysis etc), and that these policies are developed by senior management and approved by the board of directors.

In some banks, the board's risk committee or operational risk committee approves these various risk-related policies.

At most banks, the ORMF and operational risk policies outline the scope, mandate, membership and hierarchy of relevant governance structures and forums, roles and responsibilities, linkages to organisational units, reporting lines, as well as escalation and resolution mechanisms.

Also at most banks, the ORMF is applicable across the bank including overseas branches and regions, ensuring clear accountability and responsibility for management and mitigation of operational risk, developing a common understanding of operational risk, and helping the business and operation groups to improve internal controls.

However, as noted in Principle 2, many banks said that joint ventures are not controlled by the bank and that therefore these entities are governed by a shareholder agreement which sets out its own governance programme including shareholder membership on the board, as well as agreements to share the bank's risk policies and guidelines for the joint venture to consider.

At most banks, senior management oversees operational risk in the same manner as other risks, including credit risk and market risk, in terms of identification and proposal of management policies, budget, action, and investment plans in line with the strategic goals and scope of the bank.

Regarding training (R43), as mentioned in Principle 1, most banks indicated that some form of operational risk training had been established.

For example, some banks have established online operational risk training modules.

However, many banks indicated that plans are in place to improve existing operational risk training, and several banks plan to improve operational risk training and awareness for the board of directors.

Most banks also noted that there is some coordination between the CORF and other risk management functions (R35).

For instance, the banks typically ensured that reporting by credit, market and operational risk is aligned and consistent with the risk management committee and that there is some coordination and communication between operational risk officers and other risk colleagues across initiatives.

However, some also indicated that there is room for improvement in coordination activities.

In most banks, senior management has established an operational risk committee (R39) that reports to the board's risk management committee, which is mandated to oversee the enterprise operational risk management strategy and framework.

These operational risk committees direct and coordinate the implementation of the ORMF and, in most banks, membership of that committee consists of the first line of defence, the CORF and other second line of defence control functions (eg business continuity management (BCM), compliance etc).

A few banks also noted that membership of the operational risk committee includes some board members or other senior and executive management for effective discussion and appropriate decision-making.

Most banks also noted that the operational risk committee meetings are convened regularly (R41), minutes are prepared (R42), and action items are tracked to completion.

Regarding operational risk resources, most banks noted that the resourcing and training requirements of operational risk staff are monitored by human resources, and that succession plans have been established to ensure continuation of critical operations and maintenance of expertise.

While the majority of banks rated themselves as largely or fully implemented, some banks noted that the quantity and quality of reporting on operational risk to the board could be improved, as could the board's or the risk management committee's focus on operational risk.

In addition, a few banks said that they have a relatively small corporate operational risk frameworks and have not yet established an operational risk committee.

Furthermore, a few banks have not yet established a formal process to gather inputs for reporting purposes from business or functional areas.

Based on the above observations, banks are encouraged to:

- ensure that the ORMF is approved by the board or a committee of the board;

- ensure that the CORF has sufficient stature, resources, and infrastructure, in relation to other risk management functions, to implement the ORMF;

- ensure that an operational risk committee is established;

- ensure that an effective independent challenge is applied by the second line of defence; and

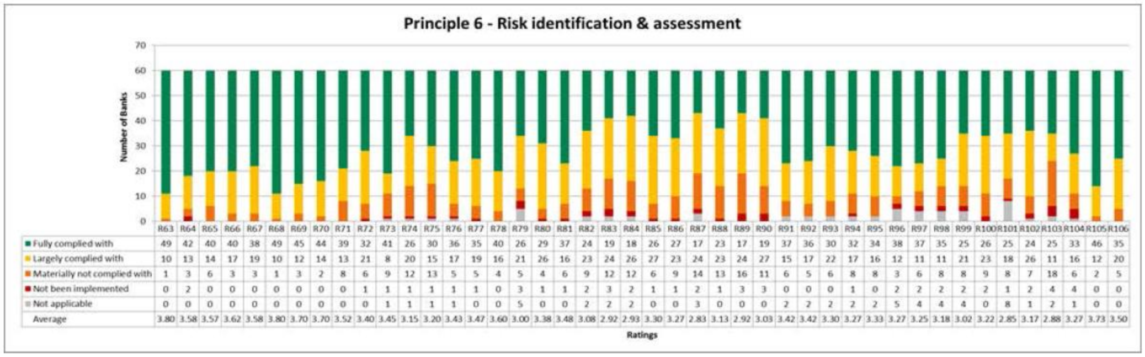
- further develop and implement their operational risk training and awareness programmes.

Principle 6: Risk identification and assessment

Senior management should ensure the identification and assessment of the operational risk inherent in all material products, activities, processes and systems to make sure the inherent risks and incentives are well understood.

The banks were asked to rate and describe the extent to which they have implemented the following operational risk identification and assessment tools:

(a) audit findings (R63–R65);
(b) internal loss data collection and analysis (R66–R72);
(c) external data collection and analysis (R73–R75);
(d) risk and control self-assessments (R76–R81);
(e) business process mapping (R82–R84);
(f) risk and performance indicators (R85–R90);
(g) scenario analysis (R91–R95);
(h) comparative analysis (R100 and 101); and
(i) other risk identification and assessment activities such as external benchmarking and creation and monitoring of action plans (R102 and R106).



	R63	R64	R65	R66	R67	R68	R69	R70	R71	R72	R73	R74	R75	R76	R77	R78	R79	R80	R81	R82	R83	R84
Fully complied with	49	42	40	40	38	49	45	44	39	32	41	26	30	36	35	40	26	29	37	24	19	18
Largely complied with	10	13	14	17	19	10	12	14	13	21	8	20	15	17	19	16	21	26	16	23	24	26
Materially not complied with	1	3	6	3	3	1	3	2	8	6	9	12	13	5	5	4	5	4	6	9	12	12
Not been implemented	0	2	0	0	0	0	0	0	0	1	1	1	1	1	1	0	3	1	1	2	3	2
Not applicable	0	0	0	0	0	0	0	0	0	0	1	1	1	1	0	0	5	0	0	2	2	2
Average	3.80	3.58	3.57	3.62	3.58	3.80	3.70	3.70	3.52	3.40	3.45	3.15	3.20	3.43	3.47	3.60	3.00	3.38	3.48	3.08	2.92	2.93

	R85	R86	R87	R88	R89	R90	R91	R92	R93	R94	R95	R96	R97	R98	R99	R100	R101	R102	R103	R104	R105	R106
Fully complied with	26	27	17	23	17	19	37	36	30	32	34	38	37	35	25	26	25	24	25	33	46	35
Largely complied with	27	23	24	23	24	27	15	17	22	17	16	12	11	11	21	23	18	26	11	16	12	20
Materially not complied with	6	9	14	13	16	11	6	5	6	8	8	3	6	8	8	9	8	7	18	6	2	5
Not been implemented	1	1	2	1	3	3	0	0	0	1	0	2	2	2	2	2	1	2	4	4	0	0
Not applicable	0	0	3	0	0	0	2	2	2	2	2	5	4	4	4	0	8	1	2	1	0	0
Average	3.30	3.27	2.83	3.13	2.92	3.03	3.42	3.42	3.30	3.27	3.33	3.27	3.25	3.18	3.02	3.22	2.85	3.17	2.88	3.27	3.73	3.50

Overall, while banks have implemented many of the operational risk identification and assessment tools, many of these tools are not fully implemented or are not being effectively used for risk management.

Some banks indicated that the tools that had been implemented were largely for risk measurement purposes, while others indicated that tools had not been fully implemented because they were not deemed necessary for risk measurement and capital calculation purposes.

In addition, a wide range of practice was reported regarding the implementation of many of these tools.

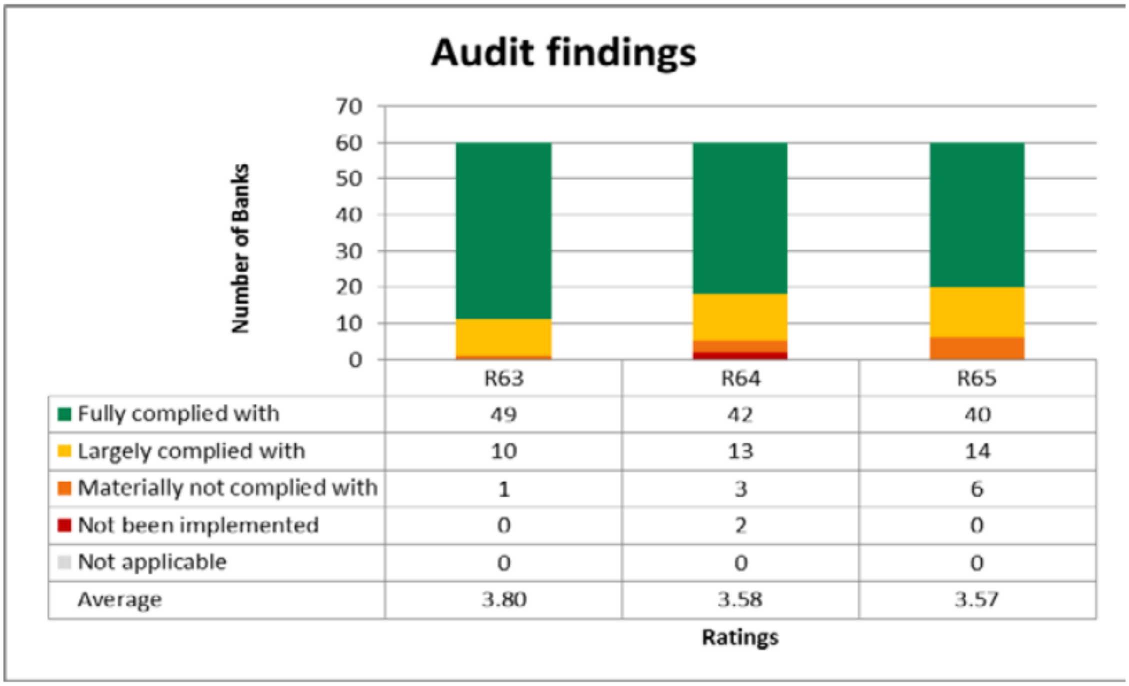
For instance, while many banks have implemented distinct, multi-tiered operational risk management tools (ie risk and control self-assessments (RCSAs), scenario analysis, business process mapping etc), other banks have chosen to implement a single tool that can serve the purpose of two or possibly three other tools (ie a scenario-based RCSA, a process-based RCSA etc).

Furthermore, some tools need considerable more focus to ensure full implementation throughout the bank including key risk and performance indicators, external data collection and analysis, comparative analysis as well as the creation and monitoring of action plans generated through the use of the operational risk management tools.

The following section summarises the observations for each of the operational risk management tools.

Audit findings

As it relates to the use of internal audit findings (R63–R65), overall, a wide range of practice was reported, and only two thirds of the banks indicated that the use of audit findings was fully implemented.



	R63	R64	R65
Fully complied with	49	42	40
Largely complied with	10	13	14
Materially not complied with	1	3	6
Not been implemented	0	2	0
Not applicable	0	0	0
Average	3.80	3.58	3.57

One of the noteworthy practices was the consideration of internal audit findings as an input to the various operational risk management tools, with this occurring most often in regard to the bank's risk and control self-assessment.

Some banks also reported that internal audit findings are used to compare management's risk and control assessments with the various tools, and that they are also used as an input to the regular updating of the bank's operational risk profile.
An additional noteworthy practice was the monitoring of the number of open and overdue internal audit issues as a key indicator.

However, several banks noted that internal audit findings are not fully considered, and a few banks noted that the operational risk management function does not have direct access to internal audit findings.

Internal loss data collection and analysis

The ratings relating to the use of internal loss data collection and analysis (R66–R72) show that, while internal loss data collection and analysis processes are more fully implemented than the other operational risk management tools, approximately one third of the banks have not yet fully implemented the underlying tool.

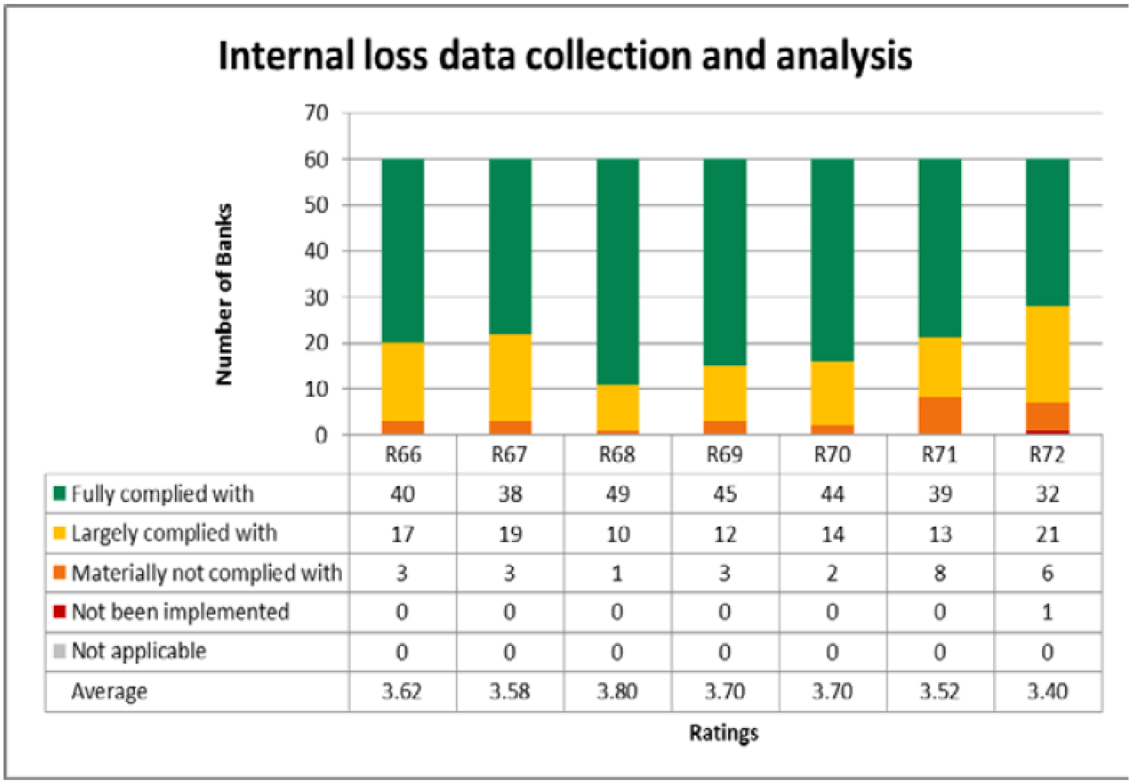
Most of the banks have a well-established process to collect internal operational loss data, with some collecting loss data above a threshold (eg $10,000 or €10,000), while some banks collect data on all operational losses, and have not established an internal threshold.

These operational losses are commonly included within risk management reports and include supporting trend analysis.

However, only a few banks collect and analyse information relating to all internal operational risk events, including losses, near-misses and profitable events.

A noteworthy practice identified by only a few banks was the establishment of an internal threshold (eg $100,000 or €100,000) whereby any operational risk event (ie losses, near-misses and profitable events) was subject to an exhaustive and standardised root cause analysis by the first line of defence, which in turn was subject to independent review and challenge by the second line of defence.

These banks noted that the operational risk management function provides the business line with supporting guidance and a standardised template to ensure a consistent approach.



	R66	R67	R68	R69	R70	R71	R72
Fully complied with	40	38	49	45	44	39	32
Largely complied with	17	19	10	12	14	13	21
Materially not complied with	3	3	1	3	2	8	6
Not been implemented	0	0	0	0	0	0	1
Not applicable	0	0	0	0	0	0	0
Average	3.62	3.58	3.80	3.70	3.70	3.52	3.40

Some banks also noted that the process involved embedding the bank's operational risk taxonomy into the template, so that this information could inform the use of the other operational risk management tools.

Additional noteworthy practices include the first line of defence leading the root cause analysis and creating action items to address any identified control deficiencies, the second line of defence closely monitoring and tracking those action items, and escalating the details of the root cause analysis and resulting action plan for items above a higher internal threshold to senior management or an operational risk committee for review.

Another noteworthy practice was the establishment of a common operational risk event template and supporting guidance to ensure a consistent approach is taken by the first line of defence across the bank's divisions.

In addition, some banks have developed a process to share details of operational risk events across business lines and geographies and encourage a similar approach to remediation where applicable.

Also, one bank noted that it uses its operational loss data to assess the quality of other operational risk tools such as the RCSA, and to review whether the associated risk or control assessment may have been evaluated improperly.

One challenge noted by some of the banks was the inability to aggregate their operational risk event data consistently in accordance with the principles referenced in the BCBS's risk data aggregation and risk reporting guidance.

While many banks have implemented central repositories for operational risk event data, others are still in the process of implementing such a repository, and that the aggregation of operational loss data remains somewhat manual.

In addition, some banks noted that, while the data are available by business line and region, they are not fully available by legal entity.

In addition, ensuring the completeness of operational risk event data remains a challenge for many banks.

While many banks have implemented a monthly reconciliation of operational losses to the bank's general ledger, a regular management attestation is commonly used that states that all business lines have reported all known events.

As it relates to the capture and analysis of operational risk boundary events (R72), some banks have established a process to collect operational loss data from market and credit risk events to gain a more holistic view of their operational risk and to support a standardised root cause analysis.

At many banks, however, this has not yet been fully implemented and such banks indicated a preference for additional guidance on the definition of an operational loss boundary event.

One bank defines operational/credit boundary events as a lending loss that would not have otherwise occurred resulting from an internal failure of people, processes, and systems.

It also defines operational/market boundary events as a loss that would not have otherwise occurred resulting from an operational event due to an internal failure of people, processes and systems, and which amounts to the realised difference between the initial value and the mark-to-market value at time of remediation.

A noteworthy practice is the establishment of a regular meeting between the operational risk management function and other risk management functions to review and discuss issues and events, including boundary losses.

External data collection and analysis

The ratings relating to the use of external data collection and analysis (R73–R75) show that fewer banks have implemented the recommended practices for using external data, as compared with the practices pertaining to the use of internal loss data.

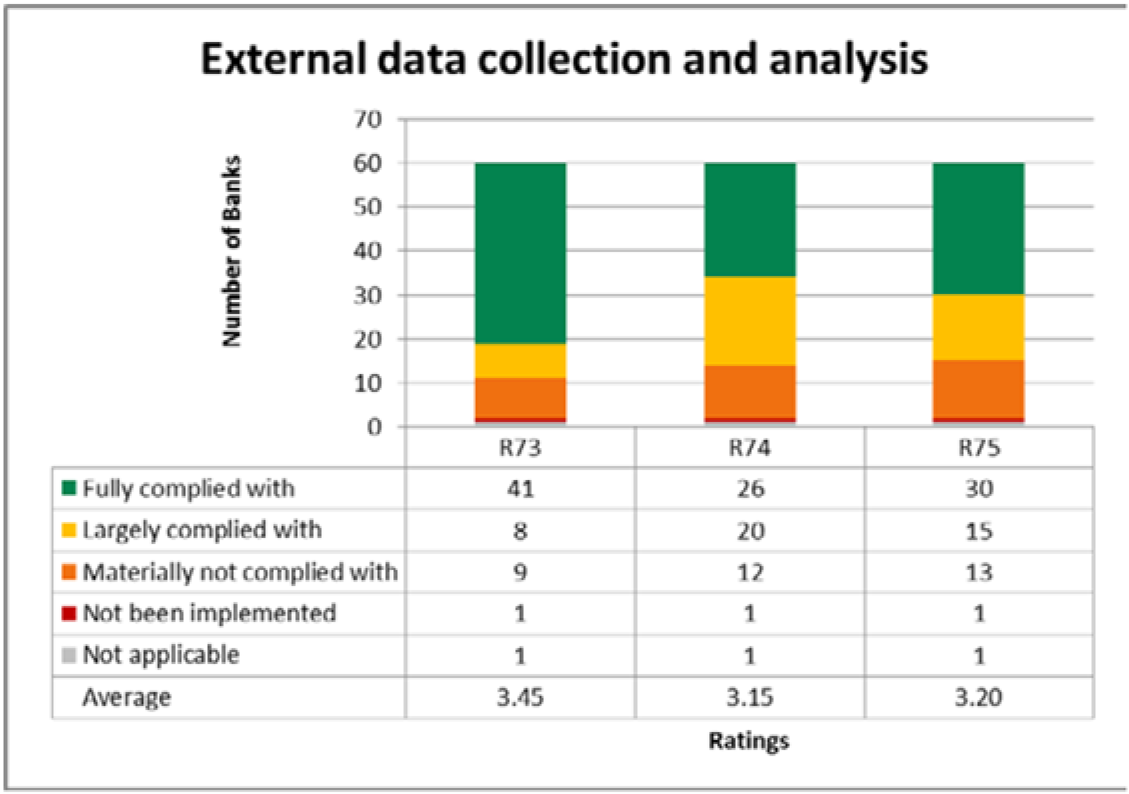
In addition, while some banks use external data for risk management purposes such as benchmarking their internal losses against external standards, as well as for key inputs into their RCSAs and scenarios, many noted that the primary and sometimes the only use of the data is for risk measurement purposes.

In a few cases, banks have not implemented the use of external loss data in their risk management programmes because they are not subject to AMA requirements.

Many banks are members of industry consortia that provide data that are used as an input for their operational risk measurement models.

The banks use these data to benchmark and assess their own internal loss data, and also as key inputs for both the scenario analysis and RCSA tools.

However, a few banks noted that their jurisdiction does not yet participate in such consortia.



	R73	R74	R75
Fully complied with	41	26	30
Largely complied with	8	20	15
Materially not complied with	9	12	13
Not been implemented	1	1	1
Not applicable	1	1	1
Average	3.45	3.15	3.20

Some banks also noted that, in the absence of consortium data or to supplement such data, they gather operational risk event data from other sources such as industry associations or media.

However, many of the banks noted that this process was performed on an ad hoc basis and could become more formalised.

A noteworthy practice was the distribution by the operational risk management function to business lines and operational risk officers of a monthly newsletter that lists all significant industry events.

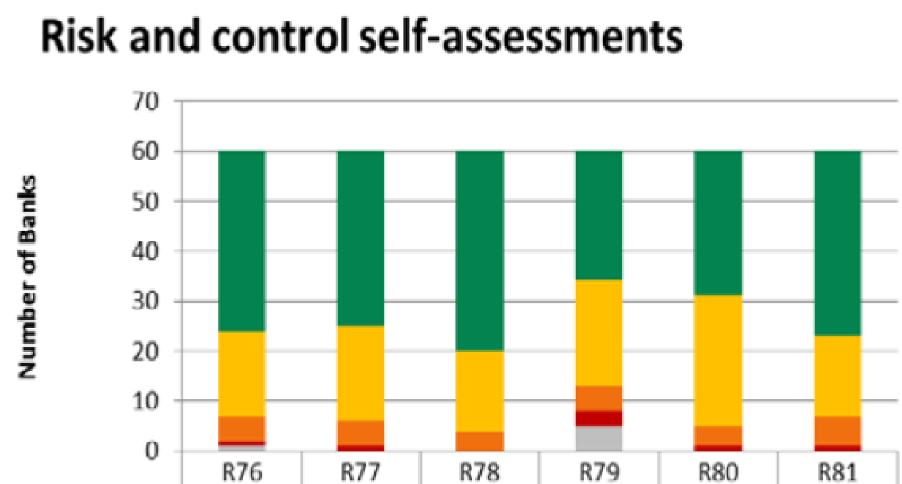
Another noteworthy practice is a monthly thematic review, whereby examples of external losses are reviewed to assess whether similar gaps exist within the bank's own business lines.

Risk and control self-assessments

While most banks have established a risk self-assessment, or a risk and control self-assessment (RCSA), many indicated that the tool has not yet been fully implemented or was currently undergoing some form of change or enhancement (R76–R81).

More specifically, fewer than half the banks indicated that the RCSA was implemented on an enterprise-wide basis (R80).

There also appears to be a very wide range of practice as to the design and implementation of these tools.



	R76	R77	R78	R79	R80	R81
Fully complied with	36	35	40	26	29	37
Largely complied with	17	19	16	21	26	16
Materially not complied with	5	5	4	5	4	6
Not been implemented	1	1	0	3	1	1
Not applicable	1	0	0	5	0	0
Average	3.43	3.47	3.60	3.00	3.38	3.48

Ratings

For instance, some banks noted that the RCSA is a distinct tool that is supplemented by a distinct scenario analysis tool and a business process mapping tool, while some noted that their RCSA was process-based and

that they have therefore not implemented a separate business process mapping tool.

Others noted that their RCSA was scenario- based, and that they had therefore not implemented a separate scenario analysis tool.

The following observations are further evidence of the wide range of practice on the design and implementation of the RCSA:

- some banks noted that the approach of their RCSA was top-down, others noted theirs was bottom-up, while others noted a multi-tiered approach (ie at the bank-wide, divisional and business line levels);

- some banks noted that the scope of the RCSA applies to current and existing functions and activities, while others indicated it applies only when there are changes made within the business unit;

- some incorporate the concepts of inherent risk, control assessment, and residual risk, while some indicated they do not incorporate all three concepts; and

- many noted that the RCSA is applied only to business units, and not control functions such as risk management, compliance and internal audit, while some noted that the RCSA applies to all groups except internal audit, and others noted that it is applied enterprise-wide to all groups including internal audit.

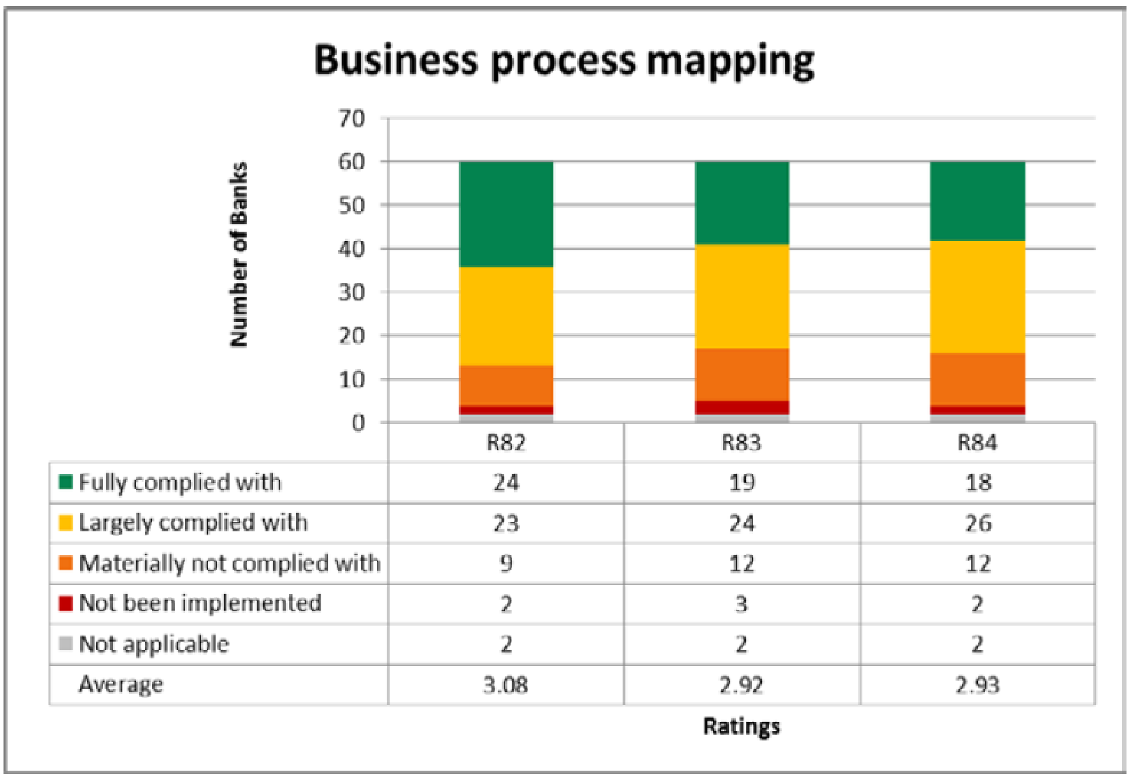
In addition, while the majority of banks indicated that all RCSAs are formally reviewed at least annually or more frequently if prompted by significant events (eg a significant operational risk event, implementation of change initiative, unsatisfactory internal audit); some banks noted the RCSAs are reviewed less frequently.

Only a small number of banks noted that their review of RCSAs follow a risk-based methodology, meaning that higher-risk businesses are reviewed more frequently than lower-risk businesses.

Noteworthy practices include the review and challenge of the RCSAs by the second line of defence, the aggregation of bank-wide themes and issues identified through the RCSAs, the embedding of the bank's operational risk taxonomy within the RCSA to ensure alignment with other tools and to allow for aggregation of a risk profile, and the completion of RCSAs not only by business unit but also for key shared business functions or processes.

One bank's methodology also involved the categorisation of residual risk into one of four categories: treat, tolerate, terminate or transfer.

Business process mapping



Overall, the use of business process mapping is one of the less implemented operational risk management tools (R82–R84). In their responses, many banks noted that, outside their financial reporting processes, they do not use business process maps as an operational risk management tool.

Some raised concerns that full implementation of this tool may require extensive effort and resources and were somewhat sceptical whether this tool would provide more value than the other operational risk management tools already implemented.

However, other banks noted that they had partially implemented this tool, although most had yet to implement it systemically across the bank.

Noteworthy practices include the implementation of a business process architecture framework that provides guidelines for the creation of business process maps, the mapping and assessment of significant and high-risk processes rather than all business processes within the bank, the establishment of a central repository for all business process maps, and the incorporation of the bank's operational risk taxonomy into the business process with a view to mapping methodology for aggregation and comparisons against the operational risk profile.

In addition, a few banks noted that the creation of relevant business process maps was the responsibility of the first line of defence, and that the second line of defence would review and apply an effective challenge to these assessments.

Risk and performance indicators

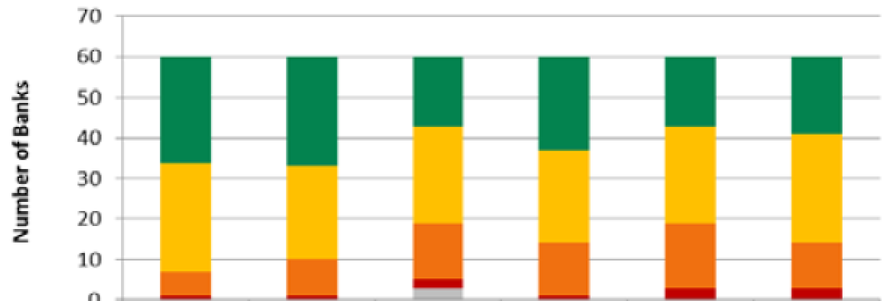
Overall, the ratings for the implementation of key risk and performance indicators were the lowest of all operational risk management tools (R85–R90).

Most banks noted that the development of key indicators was still under way across the bank, and more than half indicated that these indicators were not yet fully implemented across all business lines (R88).

In addition, a few banks have not yet implemented key risk and performance indicators in their risk management programme because they are not subject to AMA requirements, indicating that they have not considered using the tool for risk management purposes.

Generally, there appears to be broad range of interpretation for both key risk and key performance indicators.

Risk and performance indicators



	R85	R86	R87	R88	R89	R90
Fully complied with	26	27	17	23	17	19
Largely complied with	27	23	24	23	24	27
Materially not complied with	6	9	14	13	16	11
Not been implemented	1	1	2	1	3	3
Not applicable	0	0	3	0	0	0
Average	3.30	3.27	2.83	3.13	2.92	3.03

Ratings

While some banks consider key risk indicators and key performance indicators to be the same set of metrics, some banks clearly recognise that key risk indicators are metrics designed to measure inherent risk, while key performance metrics are designed to measure the adequacy of underlying processes and controls.

In addition, many of the banks noted challenges with the aggregation of common indicators as implemented in their various divisions and business lines.

Many banks that have implemented, or are upgrading this tool, said that they seek to ensure that the metrics for key operational risks (R86–R87), are regularly monitored (ie monthly or quarterly), and are measured against pre-established triggers or thresholds (R89) that often indicate the status of the risk (ie green, yellow or red).

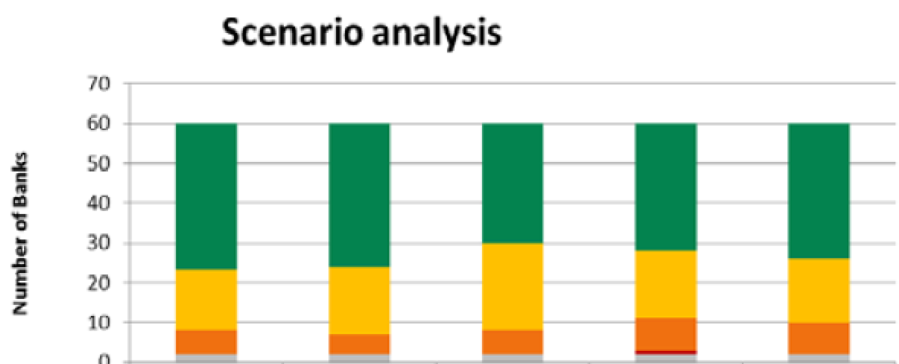
A significant number of banks also noted that further enhancements were needed to establish a more regular review process for the selected indicators and their thresholds (R90).

Noteworthy practices include the establishment of key risk and performance indicators at multiple levels throughout the bank, including at the group-wide level, the divisional level, and at the individual business line level.

Again, most banks explained that implementation was incomplete because key risk and performance indicators for business units were still under development.

Additional noteworthy practices included the first line of defence creating action plans for metrics that breached the respective thresholds, and close monitoring and challenge of indicators, thresholds, and action plans by the second line of defence.

Scenario analysis



	R91	R92	R93	R94	R95
Fully complied with	37	36	30	32	34
Largely complied with	15	17	22	17	16
Materially not complied with	6	5	6	8	8
Not been implemented	0	0	0	1	0
Not applicable	2	2	2	2	2
Average	3.42	3.42	3.30	3.27	3.33

Ratings

Overall, many banks actively use scenario analysis as a key operational risk tool (R91–R95).

However, some banks use scenario analysis on an ad hoc basis, while others use it only for risk measurement and not for risk management.

Some banks also noted that the second line of defence leads and develops the scenario process, while others noted that the first line of defence and relevant topical experts, lead the scenario analysis, with guidance and challenge provided by the second line of defence.

Noteworthy practices indicated included implementation at the bank-wide, divisional and business unit levels, the use of scenarios to assess existing controls, the opportunity to identify the additional controls required to mitigate the associated risks, and the development and monitoring of appropriate action plans.

However, overall, few banks develop action plans from their scenario analyses (R93).

Other noteworthy practices include the use of scenarios to supplement the RCSA and other operational risk management tools by focusing on low-probability but high-impact events that the other tools may have missed.

In addition, some banks said they use scenarios to compare the control environment, and help assess the completeness and adequacy of assessments in other tools (ie RCSA).

A developing practice is the use of operational risk scenarios for enterprise-wide risk assessment purposes.

For example, some banks have developed scenarios related to earthquakes and other catastrophic events such as a cyber-attack to assess not only the operational risk exposures (ie business continuity costs, fraud losses, lawsuits etc) but also other risks such as credit risk (ie increased defaults, devaluations of collateral), market risk and general economic conditions (ie lower revenues).

One bank noted that the operational risk function annually reviews the universe of scenarios, and creates a plan to develop, update, retire, reclassify or maintain the scenarios over the course of the year.

In addition, some banks have established a scenario governance committee to oversee the overall scenario programme.

Comparative analysis

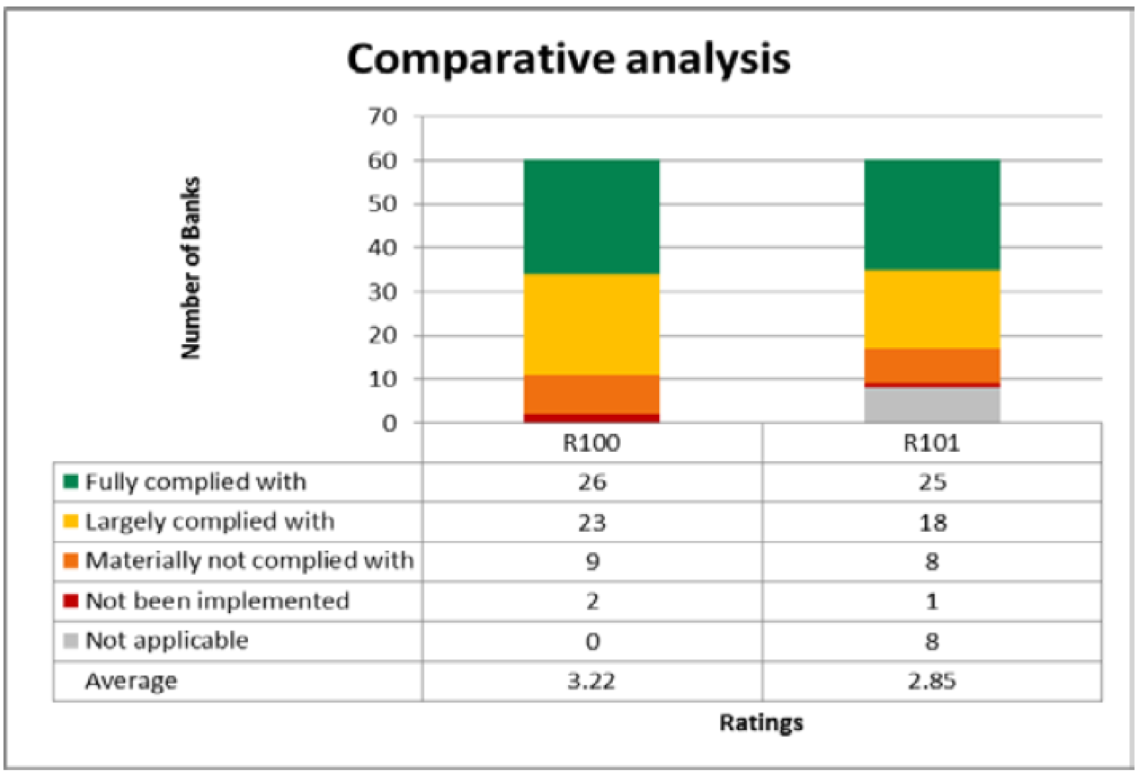
While comparative analysis is identified in the Principles as an operational risk identification and assessment tool, the chart shows that it is not widely implemented (R100).

Comments from the banks suggest that this may be because

(i) the definition and guidance provided in the Principles is limited, and

(ii) a bank needs to have most of its tools fully implemented to support a comprehensive comparative analysis programme, and as noted above, most banks are still in the process of implementing most of the tools.

But many banks indicated that they plan to enhance the quality and quantity of their comparative analysis.



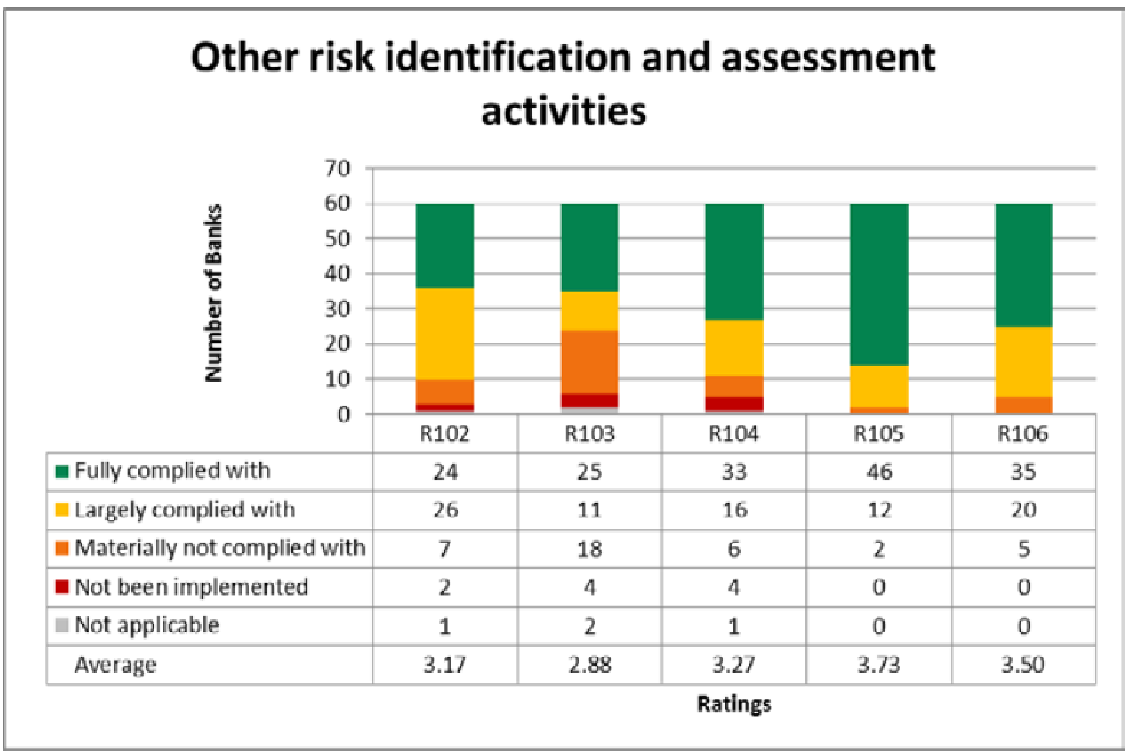
	R100	R101
Fully complied with	26	25
Largely complied with	23	18
Materially not complied with	9	8
Not been implemented	2	1
Not applicable	0	8
Average	3.22	2.85

Noteworthy practices include using the assessments and outputs of each of the tools to assess the effectiveness of other tools, comparison of tool assessments and outputs across similar business lines and geographies (ie RCSAs, operational risk events, scenarios etc), and the establishment of a formal process to conduct this comparative analysis by both the first and second lines of defence.

Other risk identification and assessment activities

Formal benchmarking of practices is not fully implemented at most banks (R102).

While banks generally noted their participation in industry forums and conferences, many said that specific practices are not generally disclosed, and only a few indicated that they conducted formal reviews by engaging a third party or by some other means.



	R102	R103	R104	R105	R106
Fully complied with	24	25	33	46	35
Largely complied with	26	11	16	12	20
Materially not complied with	7	18	6	2	5
Not been implemented	2	4	4	0	0
Not applicable	1	2	1	0	0
Average	3.17	2.88	3.27	3.73	3.50

In addition, the Principles are focused primarily on the use of operational risk identification and assessment tools for risk management rather than risk measurement exposure.

While many banks indicated that they have implemented a number of tools, or are in the process of implementing them, many noted that the creation, monitoring and remediation of action plans are not fully implemented (R106).

Overall, banks are encouraged to:

- increase their use of external data for the purposes of risk management;

- participate in industry consortia, to enhance the availability of external loss data for all jurisdictions;

- further implement the use of business process mapping as an operational risk management tool;

- further implement the use of key risk and performance indicators;

- further develop and implement comparative analysis processes that compare outputs from each tool to assess the effectiveness of other tools within business lines, as well as that of tool assessments and outputs across similar business lines and geographies;

- use operational risk scenarios for enterprise-wide risk assessment purposes;

- ensure that action plans from the operational risk identification and assessment tools are monitored;

- ensure that there is a formal process to create, monitor and remediate action plans derived from all tools; and

- consider more formal processes for benchmarking of operational risk management practices externally.

To read more: http://www.bis.org/publ/bcbs292.htm

ECB press conference - introductory statement

Mario Draghi, President of the European Central Bank, Naples

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference.

I would like to thank Governor Visco for his kind hospitality and express our special gratitude to his staff for the excellent organisation of today's meeting of the Governing Council.

We will now report on the outcome of our meeting.

Based on our regular economic and monetary analyses, and in line with our forward guidance, we decided to keep the key ECB interest rates unchanged.

Following up on the decisions of 4 September 2014, we also decided on the key operational details of both the asset-backed securities purchase programme and the new covered bond purchase programme.

This will allow us to start purchasing covered bonds and asset-backed securities (ABSs) in the fourth quarter of 2014, starting with covered bonds in the second half of October.

The programmes will last for at least two years.

Together with the series of targeted longer-term refinancing operations to be conducted until June 2016, these purchases will have a sizeable impact on our balance sheet.

The new measures will support specific market segments that play a key role in the financing of the economy.

They will thereby further enhance the functioning of the monetary policy transmission mechanism, facilitate credit provision to the broad economy and generate positive spillovers to other markets.

Taking into account the overall subdued outlook for inflation, the weakening in the euro area's growth momentum over the recent past and the continued subdued monetary and credit dynamics, our asset purchases should ease the monetary policy stance more broadly.

They should also strengthen our forward guidance on the key ECB interest rates and reinforce the fact that there are significant and increasing differences in the monetary policy cycle between major advanced economies.

Together with the monetary accommodation already in place, the determined implementation of the new measures will underpin the firm anchoring of medium to long-term inflation expectations, in line with our aim of maintaining inflation rates below, but close to, 2%.

As all our measures work their way through to the economy they will contribute to a return of inflation rates to levels closer to our aim.

Should it become necessary to further address risks of too prolonged a period of low inflation, the Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate.

A separate press release will provide further information on the modalities of our new purchase programmes for ABSs and covered bonds.

It will be released at 3.30 p.m.

Let me now explain our assessment in greater detail, starting with the economic analysis.

Following four quarters of moderate expansion, euro area real GDP remained unchanged between the first and second quarter of this year.

Survey data available up to September confirm the weakening in the euro area's growth momentum, while remaining consistent with a modest economic expansion in the second half of the year.

Looking ahead to 2015, the outlook for a moderate recovery in the euro area remains in place, but the main factors and assumptions shaping this assessment need to be monitored closely.

Domestic demand should be supported by our monetary policy measures, the ongoing improvements in financial conditions, the progress made in fiscal consolidation and structural reforms, and lower energy prices supporting real disposable income.

Furthermore, demand for exports should benefit from the global recovery.

At the same time, the recovery is likely to continue to be dampened by high unemployment, sizeable unutilised capacity, continued negative bank loan growth to the private sector, and the necessary balance sheet adjustments in the public and private sectors.

The risks surrounding the economic outlook for the euro area remain on the downside.

In particular, the recent weakening in the euro area's growth momentum, alongside heightened geopolitical risks, could dampen confidence and, in particular, private investment.

In addition, insufficient progress in structural reforms in euro area countries constitutes a key downward risk to the economic outlook.

According to Eurostat's flash estimate, euro area annual HICP inflation was 0.3% in September 2014, after 0.4% in August.

Compared with the previous month, this reflects a stronger decline in energy prices and somewhat lower price increases in most other components of the HICP.

On the basis of current information, annual HICP inflation is expected to remain at low levels over the coming months, before increasing gradually during 2015 and 2016.

The Governing Council will continue to closely monitor the risks to the outlook for price developments over the medium term.

In this context, we will focus in particular on the possible repercussions of dampened growth dynamics, geopolitical developments, exchange rate developments and the pass-through of our monetary policy measures.

Turning to the monetary analysis, data for August 2014 continue to point to subdued underlying growth in broad money (M3), with the annual growth rate increasing moderately to 2.0% in August, after 1.8% in July.

Annual growth in M3 continues to be supported by its most liquid components, with the narrow monetary aggregate M1 growing at an annual rate of 5.8% in August.

The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) remained negative at -2.0% in August, after -2.2% in the previous month.

On average over recent months, net redemptions have moderated from the historically high levels recorded a year ago.

Lending to non-financial corporations continues to reflect the lagged relationship with the business cycle, credit risk, credit supply factors and the ongoing adjustment of financial and non-financial sector balance sheets.

The annual growth rate of loans to households (adjusted for loan sales and securitisation) was 0.5% in August, broadly unchanged since the beginning of 2013.

Against the background of weak credit growth, the ECB is now close to finalising the comprehensive assessment of banks' balance sheets, which is of key importance to overcome credit supply constraints.

To sum up, a cross-check of the outcome of the economic analysis with the signals coming from the monetary analysis confirms the recent decisions taken by the Governing Council to provide further monetary policy accommodation and to support lending to the real economy.

Monetary policy is focused on maintaining price stability over the medium term and its accommodative stance contributes to supporting economic activity.

However, in order to strengthen investment activity, job creation and potential growth, other policy areas need to contribute decisively.

In particular, the legislation and implementation of structural reforms clearly need to gain momentum in several countries.

This applies to product and labour markets as well as to actions to improve the business environment for firms.

As regards fiscal policies, euro area countries should not unravel the progress already made and should proceed in line with the rules of the Stability and Growth Pact.

This should be reflected in the draft budgetary plans for 2015 that governments will now deliver, in which they will address the relevant country-specific recommendations.

The Pact should remain the anchor for confidence in sustainable public finances, and the existing flexibility within the rules should allow governments to address the budgetary costs of major structural reforms, to support demand and to achieve a more growth-friendly composition of fiscal policies.

A full and consistent implementation of the euro area's existing fiscal and macroeconomic surveillance framework is key to bringing down high public debt ratios, to raising potential growth and to increasing the euro area's resilience to shocks.

Statement at the Thirtieth Meeting of the IMFC

Statement by Mr Mario Draghi, President of the European Central Bank at the Thirtieth Meeting of the IMFC, Washington, DC.

Against the backdrop of an uneven global recovery, which is also influencing the shape and strength of the euro area upturn, the ECB has been determinedly pursuing its mandate of maintaining price stability over the medium term for the euro area.

Following four quarters of moderate expansion after two recessionary spells in the wake of first a global financial crisis and thereafter a euro area sovereign debt crisis, euro area real GDP growth remained unchanged between the first and the second quarter of this year.

Recent survey data, available up to September, confirm a weakening in the euro area's growth momentum.

Looking ahead, the recovery is expected to resume, while remaining modest.

Domestic demand is projected to be supported by our monetary policy measures, the ongoing improvements in financial conditions, the absence of fiscal headwinds on account of past progress made in fiscal consolidation and a gradual payoff of structural reforms undertaken in euro area countries.

Economic activity in the euro area is also expected to benefit from a gradual strengthening of demand for its exports.

However, unemployment in the euro area remains high and, overall, unused capacity is sizeable.

Moreover, the necessary balance sheet adjustments in the public and private sectors are likely to continue weighing on the pace of economic recovery for some time.

The risks surrounding this economic outlook remain on the downside.

The current weakening in economic momentum may postpone somewhat more the resumption in private investment, which is also negatively affected by heightened geopolitical risks.

Steadfast implementation of fiscal consolidation in a growth-friendly manner and determination in structural reform efforts should contribute to supporting business and consumer confidence going forward.

This real economy picture, together with the continued subdued monetary and credit dynamics corroborates our expectation that inflation will remain low over the coming months before increasing gradually during 2015 and 2016.

The risks to the inflation outlook will require close monitoring, which include possible repercussions of dampened growth dynamics, geopolitical as well as exchange rate developments, and the pass-through of our monetary policy measures.

It deserves to be underlined that the downward trend in euro area HICP inflation, which started in late 2011, has to a large extent been driven by global factors, such as commodity and food price developments, until earlier this year exacerbated by the appreciation of the euro exchange rate.

More recently, however, the weak level of aggregate demand has become a factor contributing to a lower than forecast inflation outcome.

Our monetary policy continues to aim at firmly anchoring medium to long-term inflation expectations, in line with our objective of maintaining inflation rates below, but close to, 2% over the medium term.

In this context, we have taken both conventional and unconventional measures that will contribute to a return of inflation rates to levels closer to our aim.

Our unconventional measures, more specifically our TLTROs (Targeted Longer-Term Refinancing Operations) and our new purchase programmes for ABSs and covered bonds, will further enhance the functioning of our monetary policy transmission mechanism and facilitate credit provision to the real economy.

Should it become necessary to further address risks of too prolonged a period of low inflation, the ECB's Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate.

As regards fiscal policies, comprehensive fiscal consolidation in recent years has contributed to reducing budgetary imbalances.

Euro area countries should not unravel the progress made with fiscal consolidation and should proceed in line with the Stability and Growth Pact.

There is room for fiscal strategies to better exploit the existing scope for a more growth-friendly composition of fiscal policies.

We therefore concur with the IMF WEO that there is a need to prioritise efficient productivity-enhancing public investment, while taking due account of the overall limited fiscal space in euro area countries.

In this respect, we also welcome the work presented in the IMF Fiscal Monitor on how well-designed fiscal strategies can support job creation.

Reducing the high tax burden on labour, while maintaining the agreed strategy of differentiated growth-friendly fiscal consolidation, is one of the Eurogroup's current policy priorities.

When looking at the structural reform picture, important steps have been taken in several euro area Member States, while in others such measures still need to be legislated and implemented.

Further efforts now clearly need to gain momentum to achieve a higher and more sustainable rate of growth in the euro area.

Determined structural reforms in product and labour markets as well as action to improve the regulatory environment for firms will encourage investment activity and job creation.

More specifically, labour markets need to be more inclusive, flexible and resilient, while product markets, including those for services, should be made more open to competition.

In addition, countries should take further steps towards improving the business environment, reducing the regulatory burden and pursuing more growth-friendly taxation.

Bold and effective implementation is not just in the interest of the individual countries, it is also key for strengthening the resilience of the Economic and Monetary Union and for supporting growth at the global level.

One domain in which the euro area has been bold and determined concerns the financial sector, and more in particular the banking sector. Indeed, important further progress on the road to banking union has been made since our previous IMFC meeting.

The ECB's legal, governance and organisational infrastructure that, as of 4 November, will support the operations of the Single Supervisory Mechanism (SSM), is close to being completed.

The Supervisory Board has been fully operational since the start of this year, helping to steer this process.

In less than one month from now, the ECB will be assuming full responsibility for the micro-prudential supervision of all banks in the euro area and more directly by becoming the single supervisor of around 120 significant banks.

Together with the national supervisors, the ECB will be enabling and facilitating coherent and consistent application of the EU Single Rule Book across the euro area in the Single Supervisory Mechanism.

As a second pillar to the Banking Union, the Single Resolution Mechanism (SRM) will start operating in the new year, even if the Single Resolution Board will only start exercising all of its responsibilities from 1 January 2016 onwards.

Based on a wider-ranging set of pertinent legal provisions in the financial regulatory domain, the banking union in Europe is about to take off, barely two years after this important decision was taken by the European Council.

One of the elements in preparation of the banking union has been the so-called Comprehensive Assessment of all significant banks in the euro area by the ECB.

It has been a challenging undertaking, involving almost 85% of the total balance sheet of euro area banks, More than 6,000 supervisors and auditors were involved in the execution of the Asset Quality Review.

An EU-wide bank stress test was added on to it. Numerous quality checks at all levels were undertaken to underpin the credibility of the exercise and to ensure level playing-field conditions across the participating countries and banks.

The results of this year-long exercise, which will become available on 26 October, will substantially increase transparency of balance sheets of European banks.

The exercise has already contributed to a further strengthening of the capital base of banks and for some of them further efforts will be needed, once the results of the comprehensive assessment are known.

The ultimate aim of the exercise is to enable euro area banks to strengthen their capital base and thereby substantially increase their credit provision capabilities.

Together with the policy measures taken by the ECB since June 2014 to further enhance the transmission of our monetary policy and support the provision of credit to the real economy, this should lead to a rebound in investment demand and growth.

To make it sustainable, economic policy makers in the euro area will need to do their part to create an environment conducive to sustainable growth.

I fully share the call of the Managing Director in her Global Policy Agenda that addressing structural deficiencies are a priority to unlock growth, at the global level and definitely also in the euro area.

Frequently asked questions on the Basel III leverage ratio framework

Introduction

In January 2014, the Basel Committee on Banking Supervision ("the Committee") published the Basel III leverage ratio framework together with the public disclosure requirements applicable as of 1 January 2015.

To promote consistent global implementation of those requirements, the Committee has agreed to periodically review frequently asked questions (FAQs) and publish answers along with any technical elaboration of the standards text and interpretative guidance that may be necessary.

Since publication, the Committee has received numerous FAQs with respect to the published standards text.

This document sets out the first set of FAQs that relate to the Basel III leverage ratio framework.

The questions and answers are grouped according to different relevant areas, which are in the order

(i) criteria for the recognition of cash variation margin associated with derivative exposures (section 1);

(ii) centrally cleared client derivative exposures (section 2);

(iii) netting of securities financing transactions (SFTs) (section 3);

(iv) the treatment of netting of SFTs and derivatives under a cross-product netting agreement (section 4); and

(v) the exposure measure under the additional treatment for credit derivatives (section 5).

1. FAQs related to the recognition of cash variation margin

1.1. Interpretation of the currency of settlement requirement

Q1. Under paragraph 25(iii), cash variation margin received must be in the same currency as the currency of settlement of the derivative contract. What does currency of settlement mean?

Relevant provisions: paragraph 25(iii) of the Basel III leverage ratio framework.

Answer: For purposes of paragraph 25(iii) of the Basel III leverage ratio framework, currency of settlement means any currency of settlement specified in the derivative contract, governing qualifying master netting agreement (MNA), or the credit support annex (CSA) to the qualifying MNA.

The above answer should be considered an interim response.

The Committee will undertake a more detailed analysis of this interpretation and the consequences of paragraph 25(iii) of the Basel III leverage ratio framework, including issues arising from foreign exchange risk due to currency mismatches between the market value of the derivatives and the associated cash variation margins.

1.2. Legal enforceability and effectiveness of a master netting agreement (MNA)

Q2. What standards are banks expected to meet for master netting agreements (MNA) to be legally enforceable and effective?

Relevant provisions: paragraph 25(v) of the Basel III leverage ratio framework.

Answer: A master netting agreement (MNA) is deemed to meet this criterion if it satisfies the conditions in paragraphs 8(c) and 9 of the Annex to the Basel III leverage ratio framework and disclosure requirements.

1.3. Daily calculation and exchange of cash variation margin

Q3. The condition that cash variation margin must be calculated and exchanged on a daily basis may not be met for certain types of cleared derivatives (eg energy derivatives).

Will any exception for the daily calculation/exchange requirement be permitted for these types of CCPs?

Relevant provisions: paragraph 25(ii) of the Basel III leverage ratio framework.

Answer: To meet this criterion, derivative positions must be valued daily and cash variation margin must
be transferred daily to the counterparty or to the counterparty's account, as appropriate.

1.4. Exchange of cash variation margin on the subsequent morning

Q4. In the case where cash variation margin is exchanged the next morning to meet end-of-day market values, would the requirement of paragraph 25(iv) still be met?

Relevant provisions: paragraph 25(iv) together with paragraph 25(ii) of the Basel III leverage ratio framework.

Answer: Cash variation margin exchanged on the morning of the subsequent trading day based on the previous, end-of-day market values would meet this criterion, provided that the variation margin exchanged is the full amount that would be necessary to fully extinguish the mark-to-market exposure of the derivative subject to applicable threshold and minimum transfer amounts.

1.5. Non-segregation of cash variation margin

Q5. What is meant in paragraph 25 when stating that the cash received by the recipient counterparty is not segregated?
Relevant provisions: paragraph 25(i) of the Basel III leverage ratio framework.

Answer: Cash variation margin would satisfy the non-segregation criterion if the recipient counterparty has no restrictions on the ability to use the cash received (ie the cash variation margin received is used as its own cash).

Q6. Where a bank provides cash variation margin it would not necessarily have any knowledge of whether its counterparty has segregated the cash or not. What standard would need to be met to fulfil this criterion?
Relevant provisions: paragraph 25(i) of the Basel III leverage ratio framework.

Answer: This criterion would be met if the cash received by the recipient counterparty is not required to be segregated by law, regulation, or any agreement with the counterparty.

2 Frequently asked questions on the Basel III leverage ratio framework

1.6. Calculation of the net-to-gross ratio (NGR)

Q7. Paragraph 26 mentions that cash variation margin may not be used in the calculation of NGR. Is this also in the case when the conditions of paragraph 25 are met?

Relevant provisions: paragraphs 25 and 26 of the Basel III leverage ratio framework together with paragraph 10 of the Annex of the Basel III leverage ratio framework.

Answer: Cash variation margin may not be used to reduce the net-to-gross ratio (NGR), even if the conditions in paragraph 25 are fully met. Specifically, in the calculation of the NGR, cash variation margin may not reduce the net replacement cost (ie the numerator of the NGR), nor the gross replacement cost (ie the denominator of the NGR).

2. Client-clearing of affiliated entities' trade exposures

Q1. Can an affiliate entity to the bank acting as a clearing member be considered a client in the sense and for the purposes of paragraph 27?
Relevant provisions: paragraph 27 of the Basel III leverage ratio framework.

Answer: An affiliated entity to the bank acting as a clearing member (CM) may be considered a client for the purpose of paragraph 27 of the Basel III leverage ratio framework if it is outside the relevant scope of regulatory consolidation at the level at which the Basel III leverage ratio is applied.

In contrast, if an affiliate entity falls within the regulatory scope of consolidation, the trade between the affiliate entity and the CM is eliminated in the course of consolidation, but the CM still has a trade exposure to the qualifying central counterparty (QCCP), which will be considered proprietary and the exemption in the said paragraph 27 no longer applies.

3. Netting of securities financing transactions (SFTs)

Q1(a) Paragraph 33(i)(c) requires that the linkages to collateral flows between a reverse repo and repo settled on the same day not result in the unwinding of net cash settlement. What is meant by this requirement and what is the standard for meeting it?

Q1(b) How should one interpret footnote 22? Could you provide further clarity on this point, and examples of settlement system facilities that would be acceptable to qualify for netting and any that would not?

Q1(c) Can the Basel Committee define in more detail what is meant by 'net settlement' as described in paragraph 33(i)(c)? More specifically, does a transaction that has 'failed' impact the ability for that transaction to be netted?

Relevant provisions: Paragraph 33(i)(c) and footnote 22 of the Basel III leverage ratio framework.

Answer: Paragraph (33)(i)(c) and footnote 22 set out necessary requirements for settlement mechanisms which are used to settle cash payables and cash receivables in securities financing transactions (SFTs)

with the same counterparty in order to offset the cash payables against the cash receivables.

Subject to criteria 33(i)(a) and 33(i)(b) also being met, the requirements are that the transactions are subject to a settlement mechanism that results in the functional equivalence of net settlement, ie the cash flows of the transactions are equivalent, in effect, to a single net amount on the settlement date.

To achieve such equivalence, all transactions must be settled through the same settlement mechanism.

The failure of any single securities transaction in the settlement mechanism should delay settlement of only the matching cash leg or create an obligation to the settlement mechanism, supported by an associated credit facility.

Further to the requirements set out in paragraph (33)(i)(c) and footnote 22, if there is a failure of the securities leg of a transaction in such a mechanism at the end of the window for settlement in the settlement mechanism, then this transaction and its matching cash leg must be split out from the netting set and treated gross for the purposes of the Basel III leverage ratio exposure measure.

Specifically, the criteria in paragraph (33)(i)(c) and footnote 22 are not intended to preclude a Delivery-versus-Payment (DVP) settlement mechanism or other type of settlement mechanism, provided that the settlement mechanism meets the functional requirements set out in paragraph 33(i)(c).

For example, a settlement mechanism may meet these functional requirements if any failed transaction (that is, the securities that failed to transfer and the related cash receivable or payable) can be re-entered in the settlement mechanism until they are settled.

4. Netting under the Basel III leverage ratio framework for derivatives and SFTs in the presence of cross-product netting agreements

Q1. How should banks perform netting under the leverage ratio for derivatives and SFTs that are included in a cross-product netting agreement?

Relevant provisions: footnote 7 of the Basel III leverage ratio framework.

Answer: Consistent with footnote 7 of the Basel III leverage ratio framework, netting across product categories (ie derivatives and SFTs) is not permitted for the purposes of determining the Basel III leverage ratio exposure measure.

However, where a bank has a cross-product netting agreement in place that meets the eligibility criteria of paragraphs 8 and 9 of the Annex of the Basel III leverage ratio framework, it may choose to perform netting separately in each product category provided that all other conditions for netting in this product category that are applicable to the Basel III leverage ratio are met.

5. The meaning of a negative change in fair value

Q1. What is meant by negative change in fair value in paragraph 30 of the Basel III leverage ratio framework?

Relevant provisions: Paragraph 30 of the Basel III leverage ratio framework.

A negative change in fair value is meant to refer to a negative fair value of a credit derivative that is recognised in Tier 1 capital.

This treatment is consistent with the Committee's communicated rationale that the effective notional amounts included in the exposure measure may be capped at the level of the maximum potential loss, which means the maximum potential loss at the reporting date is the notional amount of the credit derivative minus any negative fair value that has already reduced Tier 1 capital.

For example, if a written credit derivative had a positive fair value of 20 on one date and has a negative fair value of 10 on a subsequent reporting date, the effective notional amount of the credit derivative may be reduced by 10.

The effective notional amount cannot be reduced by 30.

However, if at the subsequent reporting date the credit derivative has a positive fair value of 5, the effective notional amount cannot be reduced at all.

Corporate governance principles for banks - consultative document

Introduction

1. Effective corporate governance is critical to the proper functioning of the banking sector and the economy as a whole.

Banks serve a crucial role in the economy by intermediating funds from savers and depositors to activities that support enterprise and help drive economic growth.

Banks' safety and soundness are key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health.

Governance weaknesses at banks that play a significant role in the financial system can result in the transmission of problems across the banking sector and the economy as a whole.

2. Corporate governance determines the allocation of authority and responsibilities by which the business and affairs of a bank are carried out by its board and senior management, including how they:

- set the bank's strategy and objectives;

- select and oversee personnel;

- operate the bank's business on a day-to-day basis;

- protect the interests of depositors, meet shareholder obligations, and take into account the interests of other recognised stakeholders;

- align corporate culture, corporate activities and behaviour with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable laws and regulations; and
- establish control functions.

3. Supervisors have a keen interest in sound corporate governance as it is an essential element in the safe and sound functioning of a bank and may adversely affect the bank's risk profile if not operating effectively.

Well governed banks contribute to the maintenance of an efficient and cost-effective supervisory process, as there is less need for supervisory intervention.

4. Sound corporate governance may permit the supervisor to place more reliance on the bank's internal processes.

In this regard, supervisory experience underscores the importance of having the appropriate levels of authority, responsibility, accountability, and checks and balances within each bank, including those of senior management but also of the board of directors and the risk, compliance and internal audit functions.

5. The Basel Committee's October 2010 Principles for enhancing corporate governance represented a consistent development in the Committee's longstanding efforts to promote sound corporate governance practices for banking organisations.

The 2010 principles sought to reflect key lessons from the 2008–09 financial crisis, and enhance how banks govern themselves and how supervisors oversee this critical area.

6. Since 2010, the Committee and its member jurisdictions have witnessed banks strengthening their overall governance practices and supervisors enhancing their oversight processes.

- In general, banks exhibit a better understanding of the important elements of corporate governance such as effective board oversight, rigorous risk management, strong internal controls, compliance and other related areas.

In addition, many banks have made progress in assessing collective board skills and qualifications, instituting standalone board risk committees, establishing and elevating the role of Chief Risk Officer

(CRO), and integrating discussions between board audit and risk committees.

• National authorities have taken measures to improve regulatory and supervisory oversight of corporate and risk governance at banks.

These measures include developing or strengthening existing regulation or guidance, raising supervisory expectations for the risk management function, engaging more frequently with the board and management, and assessing the accuracy and usefulness of the information provided to the board.

7. In order to assess the progress of national authorities and the banking industry in the area of risk governance since the global financial crisis, the Financial Stability Board (FSB) issued a Thematic review on risk governance in February 2013 as part of its series of peer reviews.

The peer review found that financial institutions and national authorities have taken measures to improve risk governance.

However, more work is needed by both national authorities and banks to establish effective risk governance frameworks and to enumerate expectations for third-party reviews of the framework.

Banks also need to enhance the authority and independence of CROs.

National authorities need to strengthen their ability to assess the effectiveness of a bank's risk governance and its risk culture and should engage more frequently with the board and its risk and audit committees.

8. In the light of ongoing developments in corporate governance, and to take account of the FSB peer review recommendations and other recent papers addressing corporate governance issues, the Committee has decided to revisit the 2010 guidance.

9. One of the primary objectives of this revision is to explicitly reinforce the collective oversight and risk governance responsibilities of the board.

Another important objective is to emphasise key components of risk governance such as risk culture, risk appetite and their relationship to a bank's risk capacity.

The revised guidance also delineates the specific roles of the board, board risk committees, senior management and the control functions including the CRO and internal audit.

Another key emphasis is strengthening banks' overall checks and balances.

10. Importantly, the FSB underscored the critical role of the board and the board risk committees in strengthening a bank's risk governance.

This includes greater involvement in evaluating and promoting a strong risk culture in the organisation; establishing the organisation's risk appetite and conveying it through the risk appetite statement (RAS); and overseeing management's implementation of the risk appetite and overall governance framework.

11. The increased focus on risk and the supporting governance framework includes identifying the responsibilities of different parts of the organisation for addressing and managing risk.

Often referred to as the "three lines of defence", each of the three lines has an important role to play.

The business line – the first line of defence – has "ownership" of risk whereby it acknowledges and manages the risk that it incurs in conducting its activities.

The risk management function is responsible for further identifying, measuring, monitoring and reporting risk on an enterprise-wide basis as part of the second line of defence, independently from the first line of defence.

The compliance function is also deemed part of the second line of defence.

The internal audit function is charged with the third line of defence, conducting risk-based and general audits and reviews to provide assurance to the board that the overall governance framework, including the risk governance framework, is effective and that policies and processes are in place and consistently applied.

Jurisdictional differences

12. This document is intended to guide the actions of board members, senior managers, control function heads and supervisors of a diverse range of banks in a number of countries with varying legal and regulatory systems, including both Committee member and non-member jurisdictions.

The Committee recognises that there are significant differences in the legislative and regulatory frameworks across countries, which may restrict the application of certain principles or provisions therein.

Each jurisdiction should apply the provisions as the national authorities see fit.

In some cases, this may involve legal change. In other cases, a principle may require slight modification in order to be implemented.

Applicability, proportionality and differences in governance approaches

13. The implementation of these principles should be commensurate with the size, complexity, structure, economic significance and risk profile of the bank and the group (if any) to which it belongs.

This means making reasonable adjustments where appropriate for banks with lower risk profiles, and being alert to the higher risks that may accompany more complex and publicly listed institutions.

Systemically important financial institutions (SIFIs) are expected to have in place the corporate governance structure and practices commensurate

with their role in and potential impact on national and global financial stability.

14. The principles set forth in this document are applicable regardless of whether or not a jurisdiction chooses to adopt the Committee's regulatory framework.

The board and senior management at each bank have an obligation to pursue good governance.

15. This document refers to a governance structure composed of a board of directors and senior management.

The latter is sometimes called the executive committee, the executive board or the management board.

Some countries use a formal two-tier structure, where the supervisory function of the board is performed by a separate entity known as a supervisory board or audit and supervisory board, which has no executive functions.

Other countries use a one-tier structure in which the board of directors has a broader role.

Still other countries have moved or are moving to a mixed approach that discourages or prohibits executives from serving on the board of directors or limits their number and/or requires the board and board committees to be chaired only by non-executive or independent board members.

Some countries also prohibit the CEO from serving as chair of the board of directors or even from being part of the board of directors.

16. Owing to these differences, this document does not advocate any specific board or governance structure.

The term board of directors is used as a way to refer to the oversight function and the term senior management as a way to refer to the management function in general.

These terms should be interpreted throughout the document in accordance with the applicable law within each jurisdiction.

Recognising that different structural approaches to corporate governance exist across countries and that these structures evolve over time, this document encourages legislators, supervisors, banks and others to frequently review their practices so as to strengthen checks and balances and sound corporate governance under diverse structures.

The application of corporate governance standards in any jurisdiction is naturally expected to be pursued in a manner consistent with applicable national laws, regulations and codes (eg taking into consideration the existence of oversight boards in some jurisdictions).

17. One fundamental corporate governance issue in respect of publicly listed companies is shareholder rights.

Such rights are not the primary focus of this guidance and are addressed in the corporate governance principles issued by the OECD.

However, the Committee recognises the importance of shareholder rights and of responsible shareholder engagement.

The Committee also recognises the importance of exercise of shareholder rights, particularly when certain shareholders have the right to have a representative on the board.

In such cases, the suitability of the appointed board member is as critical as their awareness of the responsibility to look after the interests of the bank as a whole, not just of the shareholders.

18. Effective implementation of sound corporate governance requires relevant legal, regulatory and institutional foundations.

A variety of factors, including the system of business laws, stock exchange rules and accounting standards, can affect market integrity and systemic stability.

Such factors, however, are often outside the scope of banking supervision.

Supervisors are nevertheless encouraged to be aware of legal and institutional impediments to sound corporate governance, and to take steps to foster effective foundations for corporate governance where it is within their legal authority to do so.

Where it is not, supervisors may wish to consider supporting legislative or other reforms that would allow them to have a more direct role in promoting or requiring sound corporate governance.

19. The principles of sound corporate governance should also be applied to state-owned or state- supported banks, including when such support is temporary.

Principle 1: Board's overall responsibilities

The board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, governance framework and corporate culture. The board is also responsible for providing oversight of senior management.

Responsibilities of the board

20. The board has ultimate responsibility for the bank's business strategy and financial soundness, key personnel decisions, internal organisation and governance structure and practices, and risk management and compliance obligations.

21. The board should ensure that the bank's organisational structure enables the board and senior management to carry out their responsibilities and facilitates effective decision-making and good governance.

This includes clearly laying out the key responsibilities and authorities of the board itself, of senior management and of those responsible for the control functions.

22. The members of the board should exercise their "duty of care" and "duty of loyalty" to the bank under applicable national laws and supervisory standards.

This includes actively engaging in the major matters of the bank and keeping up with material changes in the bank's business and the external environment as well as acting in a timely manner to protect the long-term interests of the bank.

23. Accordingly, the board should:

- establish and monitor the bank's business objectives and strategy;

- establish the bank's corporate culture and values;

- oversee implementation of the appropriate governance framework;

- develop, along with senior management and the CRO, the bank's risk appetite, taking into account the competitive and regulatory landscape, long-term interests, exposure to risk and the ability to manage risk effectively;

- monitor the bank's adherence to the RAS, risk policy and risk limits;

- approve and oversee the implementation of the bank's capital adequacy assessment process, capital and liquidity plans, compliance policies and obligations, and the internal control system;

- approve the selection and oversee the performance of senior management; and

- oversee the design and operation of the bank's compensation system, and monitor and review the system to ensure that it is aligned with the bank's desired risk culture and risk appetite.

24. The board should ensure that transactions with related parties (including internal group transactions) are reviewed to assess risk and are subject to appropriate restrictions (eg by requiring that such transactions be conducted on arm's length terms) and that corporate or business resources of the bank are not misappropriated or misapplied.

25. The board should review the governance framework periodically so that it remains appropriate in the light of material changes in the bank's size, complexity, geographic reach, business strategy, market and governance best practices, and regulatory requirements.

26. In discharging these responsibilities, the board should take into account the legitimate interests of depositors, shareholders and other relevant stakeholders. It should also ensure that the bank maintains an effective relationship with its supervisors.

Corporate culture and values

27. A fundamental component of good governance is a demonstrated corporate culture of reinforcing appropriate norms for responsible and ethical behaviour.

These norms are especially critical in terms of a bank's risk awareness, risk-taking and risk management.

28. In order to promote a sound corporate culture, the board should take the lead in establishing the "tone at the top" by:

- **setting and adhering to corporate values for itself, senior management and other employees that create expectations that all business should be conducted in a legal and ethical manner;**

- **promoting risk awareness within a strong risk culture, conveying the board's expectation that it does not support excessive risk-taking and that all employees are responsible for helping ensure that the bank operates within the agreed risk appetite and risk limits;**

- **ensuring that appropriate steps are taken to communicate throughout the bank the corporate values, professional standards or codes of conduct it sets, together with supporting policies; and**

- **ensuring that employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviours and transgressions.**

29. A bank's code of conduct or code of ethics, or comparable policy, should define acceptable and unacceptable behaviours.

- It should explicitly disallow behaviour that could lead to any reputation risks or improper or illegal activity, such as financial misreporting, money laundering, fraud, anti-competitive practices, bribery and corruption, or the violation of consumer rights.

- It should make clear that employees are expected to conduct themselves ethically in addition to complying with laws, regulations and company policies.

30. The bank's corporate values should recognise the critical importance of timely and frank discussion and escalation of problems to higher levels within the organisation.

- Employees should be encouraged and able to communicate, confidentially and without the risk of reprisal, legitimate concerns about illegal, unethical or questionable practices.

This can be facilitated through a well communicated policy and adequate procedures and processes, consistent with national law, which allow employees to communicate material and bona fide concerns and observations of any violations in a confidential way (eg whistle blower policy).

This includes communicating material concerns to the bank's supervisor.

- There should be direct or indirect communications to the board (eg through an independent audit or compliance process or through an ombudsman independent of the internal "chain of command").

- The board should determine how and by whom legitimate concerns shall be investigated and addressed by an objective independent internal or external body, senior management and/or the board itself.

Risk appetite, management and control

31. As part of the overall corporate governance framework, the board is responsible for overseeing a strong risk governance framework.

An effective risk governance framework includes a strong risk culture, a well developed risk appetite framework articulated through the RAS, and well defined responsibilities for risk management in particular and control functions in general.

32. Developing and conveying the bank's RAS is essential to reinforcing a strong risk culture.

The board should clearly outline actions to be taken when stated risk limits are breached, including disciplinary actions for excessive risk-taking, escalation procedures and board of director notification.

33. The board should take an active role in developing the risk appetite and ensuring its alignment with the bank's strategic, capital and financial plans and compensation practices.

The bank's risk appetite should be clearly conveyed through an RAS that is easily understood by all relevant parties: the board itself, senior management, bank employees and the supervisor.

34. The bank's RAS should:

- include both quantitative and qualitative considerations;

- establish the individual and aggregate level and types of risk that the bank is willing to assume in advance of and in order to achieve its business activities within its risk capacity;

- define the boundaries and business considerations in accordance with which the bank is expected to operate when pursuing the business strategy; and

- communicate the board's risk appetite effectively throughout the bank, linking it to daily operational decision-making and establishing the means to raise risk issues and strategic concerns across the bank.

35. The development of an effective RAS should be driven by both top-down board leadership and bottom-up management involvement.

While risk appetite development may be initiated by senior management, successful implementation depends upon effective interactions between the board, senior management, risk management and operating businesses including the chief financial officer.

36. A risk governance framework should include well defined organisational responsibilities for risk management, typically referred to as the three lines of defence:

- **the business line;**

- **a risk management function and a compliance function independent from the first line of defence; and**

- **an internal audit function independent from the first and second lines of defence.**

37. Depending on the bank's nature, size and complexity, and the risk profile of its activities, the specifics of how these three lines of defence are structured can vary.

Regardless of the structure, responsibilities for each line of defence should be well defined and communicated.

38. Business units are the first line of defence.

They take risks and are responsible and accountable for the ongoing management of such risks.

This includes identifying, assessing and reporting such exposures, taking into account the bank's risk appetite and its policies, procedures and controls.

The manner in which the business line executes its responsibilities should reflect the bank's existing risk culture.

39. The second line of defence includes an independent and effective risk management function.

The risk management function complements the business line's risk activities through its monitoring and reporting responsibilities.

Among other things, it is responsible for overseeing the bank's risk-taking activities and assessing risks and issues independently from the business line.

The function should promote the importance of senior management and business line managers in identifying and assessing risks critically rather than relying only on surveillance conducted by the risk management function.

40. The second line of defence also includes an independent and effective compliance function.

The compliance function should, among other things, routinely monitor compliance with laws, corporate governance rules, regulations, codes and policies to which the bank is subject.

The board should approve compliance policies that are communicated to all staff.

The compliance function should ensure that the compliance policies are observed and report to senior management and, as appropriate, to the board on how the bank is managing its compliance risk.

The function should also have sufficient authority, stature, independence, resources and access to the board.

41. The third line of defence consists of an independent and effective internal audit function.

Among other things, it provides independent review and assurance on the quality and effectiveness of the bank's risk governance framework including links to organisational culture, as well as strategic and business planning, compensation and decision-making processes.

Internal auditors must be competent and appropriately trained and not involved in developing, implementing or operating the risk management function (see Principle 9).

42. The board should ensure that the risk management, compliance and audit functions are properly positioned, staffed and resourced and carry out their responsibilities independently and effectively.

In the board's oversight of the risk governance framework, the board should regularly review policies and controls with senior management and with the heads of the risk management, compliance and audit functions to identify and address significant risks and issues, as well as determine areas that need improvement.

Oversight of senior management

43. The board should select the CEO and may select other key members of senior management, as well as the heads of the control functions.

44. The board should provide oversight of senior management.

It should hold members of senior management accountable for their actions and enumerate the consequences if those actions are not aligned with the board's performance expectations.

This includes adhering to the bank's values, risk appetite and risk culture, regardless of financial gain or loss to the bank.

In doing so, the board should:

- monitor that senior management's actions are consistent with the strategy and policies approved by the board, including the risk appetite;

- meet regularly with senior management;

- question and critically review explanations and information provided by senior management;

- set appropriate performance and remuneration standards for senior management consistent with the long-term strategic objectives and the financial soundness of the bank;

- ensure that senior management's knowledge and expertise remain appropriate given the nature of the business and the bank's risk profile; and

- ensure that appropriate succession plans are in place for senior management positions.

Principle 2: Board qualifications and composition

Board members should be and remain qualified, individually and collectively, for their positions. They should understand their oversight and corporate governance role and be able to exercise sound, objective judgment about the affairs of the bank.

Board composition

45. The board must be suitable to carry out its responsibilities and have a composition that facilitates effective oversight.

For that purpose, the board should be comprised of a sufficient number of independent directors.

46. The board should be comprised of individuals with a balance of skills, diversity and expertise, who collectively possess the necessary qualifications commensurate with the size, complexity and risk profile of the bank.

47. In assessing the collective suitability of the board, the following should be taken into account:

- Board members should have a range of knowledge and experience in relevant areas and have varied backgrounds to promote diversity of views.

Relevant areas of competence include financial and capital markets, financial analysis, financial stability, strategic planning, risk management, compensation, regulation, corporate governance and management skills.

• The board collectively should have a reasonable understanding of local, regional and, if appropriate, global economic and market forces and of the legal and regulatory environment.

International experience, where relevant, should also be considered.

• Where board expertise is insufficient in any of the above areas, the board should be able to employ independent experts as needed.

Board member selection and qualifications

48. Boards should have a clear and rigorous process for identifying, assessing and selecting board candidates.

Unless required otherwise by law, the board (not management) identifies and nominates candidates and ensures appropriate succession planning of board members and senior management.

49. The selection process should include reviewing whether board candidates:

(i) possess the knowledge, skills, experience and independence of mind given their responsibilities on the board and in the light of the bank's business and risk profile;

(ii) have a record of integrity and good repute; and

(iii) have sufficient time to fully carry out their responsibilities.

50. Board candidates should not have any conflicts of interest that may impede their ability to perform their duties objectively and subject them to undue influence from:

• other persons (such as management or other shareholders);

- past or present positions held; or

- personal, professional or other economic relationships with other members of the board or management (or with other entities within the group).

51. If a board member ceases to be qualified or is failing to fulfil his or her responsibilities, the board should take appropriate actions as permitted by law, which may include notifying their banking supervisor.

52. The bank should have in place a nomination committee or similar body, composed of a sufficient number of independent board members, which identifies and nominates candidates after having taken into account the criteria described above.

- The nomination committee should analyse the responsibilities relating to the role the board member will play and the knowledge, experience and competence which the role requires.

- Where a supervisory board or board of auditors is formally separate from a management board, objectivity and independence still need to be assured by appropriate selection of board members.

- The nomination committee should strive to ensure that the board is not dominated by any one individual or small group of individuals in a manner that is detrimental to the interests of the bank as a whole.

53. In order to help board members acquire, maintain and enhance their knowledge and skills, and fulfil their responsibilities, the board should ensure that members participate in induction programmes and have access to ongoing training on relevant issues.

The board should dedicate sufficient time, budget and other resources for this purpose, and draw on external expertise as needed.

More extensive efforts should be made to train and keep updated those members with more limited financial, regulatory or risk-related experience.

54. Where there are shareholders with power to appoint board members, the board should ensure such board members understand their duties.

Board members have responsibilities to the bank's overall interests, regardless of who appoints them.

In cases where board members are selected by a controlling shareholder, the board may wish to set out specific procedures or conduct periodic reviews to ensure the appropriate discharge of responsibility by all board members.

Principle 3: Board's own structure and practices

The board should define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.

Organisation and assessment of the board

55. The board should structure itself in terms of leadership, size and the use of committees so as to effectively carry out its oversight role and other responsibilities.

This includes ensuring that the board has the time and means to cover all necessary subjects in sufficient depth and have a robust discussion of issues.

56. The board should maintain and periodically update organisational rules, by-laws, or other similar documents setting out its organisation, rights, responsibilities and key activities.

57. To support its own performance, the board should carry out regular assessments – alone or with the assistance of external experts – of the board as a whole, its committees and individual board members.

The board should:

- **periodically review its structure, size and composition;**

• assess the ongoing suitability of each board member periodically (at least annually) also taking into account his or her performance on the board;

• either separately or as part of these assessments, periodically review the effectiveness of its own governance practices and procedures, determine where improvements may be needed, and make any necessary changes; and

• use the results of these assessments as part of the ongoing improvement efforts of the board and, where required by the supervisor, share results with the supervisor.

58. The board should maintain appropriate records (eg meeting minutes or summaries of matters reviewed, recommendations made and decisions taken) of its deliberations and decisions.

These should be made available to the supervisor when required.

Role of the chair

59. The chair of the board plays a crucial role in the proper functioning of the board.

The chair provides leadership to the board and is responsible for its effective overall functioning, including maintaining a relationship of trust with board members.

The chair should possess the requisite experience, competencies and personal qualities in order to fulfil these responsibilities.

The chair should ensure that board decisions are taken on a sound and well informed basis.

The chair should encourage and promote critical discussion and ensure that dissenting views can be freely expressed and discussed within the decision-making process.

60. **To promote checks and balances, the chair of the board should be a non-executive board member and not serve as chair of any board committee.**

61. **In jurisdictions where the chair is permitted to assume executive duties, the bank should have measures in place to mitigate the adverse impact on the bank's checks and balances of such a situation.**

These could include having a lead board member, senior independent board member or a similar position or having a larger number of non-executives on the board so as to provide effective challenge to executive board members.

Board committees

62. **To increase efficiency and allow deeper focus in specific areas, a board may establish certain specialised board committees, unless it can demonstrate to the supervisor that it can still effectively accomplish the goals described below without such committees.**

The committees should be created and mandated by the full board.

The number and nature of committees depends on many factors, including the size of the bank and its board, the nature of the business areas of the bank, and its risk profile.

63. **Each committee should have a charter or other instrument that sets out its mandate, scope and working procedures.**

This includes how the committee will report to the full board, what is expected of committee members and any tenure limits for serving on the committee.

The board should consider the occasional rotation of members and of the chair of such committees as this can help avoid undue concentration of power and promote fresh perspectives.

64. **In the interest of greater transparency and accountability, a board should disclose the committees it has established, their mandates and**

their composition (including members who are considered to be independent).

65. Committees should maintain appropriate records of their deliberations and decisions (eg meeting minutes or summaries of matters reviewed, recommendations made and decisions taken).

Such records should document the committees' fulfilment of their responsibilities and help the supervisor or those responsible to assess the effectiveness of these committees.

66. A committee chair should be an independent, non-executive board member.

Audit committee

67. The audit committee:

- is required for systemically important banks.

For banks of large size, risk profile or complexity it is strongly advised. For other banks it remains strongly recommended.

- is required to be distinct from other committees.

- should have a chair who is independent and is not the chair of the board or any other committee.

- should be made up entirely of independent or non-executive board members.

- should include members who have experience in audit practices and financial literacy at banks.

68. The audit committee is responsible, among other things, for:

- the financial reporting process;

•	providing oversight of and interacting with the bank's internal and external auditors;

•	approving, or recommending to the board or shareholders for their approval, the appointment compensation and dismissal of external auditors;

•	reviewing and approving the audit scope and frequency

•	receiving key audit reports and ensuring that senior management is taking necessary corrective actions in a timely manner to address control weaknesses, non-compliance with policies, laws and regulations and other problems identified by auditors and other control functions;

•	overseeing the establishment of accounting policies and practices by the bank; and

•	reviewing the third-party opinions on the design and effectiveness of the overall risk governance framework and internal control system.

69.	At a minimum, the audit committee as a whole should possess a collective balance of skills and expert knowledge – commensurate with the complexity of the banking organisation and the duties to be performed – and should have relevant experience in financial reporting, accounting and auditing.

Where needed, the audit committee has access to external expert advice.

Risk committee

70.	The risk committee of the board:

•	is required for systemically important banks.

For banks of large size, risk profile or complexity it is strongly advised.

For other banks it remains strongly recommended.

• should be distinct from the audit committee, but may have other related tasks, such as finance.

• should have a chair who is an independent director and not the chair of the board, or any other committee.

• should include a majority of members who are independent.

• should include members who have experience in risk management issues and practices.

• should discuss all risk strategies on both an aggregated basis and by type of risk and make recommendations to the board thereon, and on the risk appetite.

• is required to review the bank's risk policies at least annually.

• should oversee that management has in place processes to ensure the bank's adherence to the approved risk policies.

71. The risk committee of the board is responsible for advising the board on the bank's overall current and future risk appetite, overseeing senior management's implementation of the RAS, reporting on the state of risk culture in the bank, and interacting with and overseeing the CRO.

72. The committee's work includes oversight of the strategies for capital and liquidity management, as well as for all relevant risks of the bank, such as credit, market, operational, compliance and reputational risks, to ensure they are consistent with the stated risk appetite.

73. The committee should receive regular reporting and communication from the CRO and other relevant functions about the bank's current risk profile, current state of the risk culture, utilisation against the established risk appetite and limits, limit breaches and mitigation plans (see Principle 6).

74. The risk committee should meet periodically with the audit and other risk-relevant committees to ensure effective exchange of information and effective coverage of all risks, including emerging risks

and any needed adjustments to the risk governance framework of the bank in the light of its business plans and the external environment.

Compensation committee

75. The compensation committee is required for systemically important banks.

It should oversee the compensation system's design and operation and ensure that compensation is appropriate and consistent with the bank's culture, long-term business and risk appetite, performance and control environment (see Principle 10), as well as with any legal or regulatory requirements.

The compensation committee should be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives they create.

The compensation committee works closely with the bank's risk committee in evaluating the incentives created by the compensation system.

Other board committees

76. Among other specialised committees that have become increasingly common are the following:

- Nominations/human resources/governance committee: provides recommendations to the board for new board members and members of senior management; may be involved in assessment of board and senior management effectiveness; may be involved in overseeing the bank's personnel or human resource policies (see Principle 2).

- Ethics/compliance committee: ensures that the bank has the appropriate means for promoting proper decision-making and compliance with laws, regulations and internal rules; provides oversight of the compliance function.

77. The board should appoint members to specialised committees with the goal of achieving an optimal mix of skills and experience that, in combination, allow the committees to fully understand, objectively evaluate and bring fresh thinking to the relevant issues.

78. In jurisdictions permitting or requiring executive members on the board, the board of a bank should work to ensure the needed objectivity in each committee, such as by having only non-executives and, to the extent possible, a majority of independent members.

Conflicts of interest

79. Conflicts of interest may arise as a result of the various activities and roles of the bank (eg where the bank extends loans to a firm while its proprietary trading function buys and sells securities issued by that firm), or between the interests of the bank or its customers and those of the bank's board members or senior managers (eg where the bank enters into a business relationship with an entity in which one of the bank's board members has a financial interest).

80. Conflicts of interest may also arise when a bank is part of a broader group.

For example, where the bank is part of a group, reporting lines and information flows between the bank, its parent company and/or other subsidiaries can lead to the emergence of conflicts of interest (eg sharing of potential proprietary, confidential or otherwise sensitive information from different entities or pressure to conduct business on a non-arm's length basis).

81. The board should ensure that policies to identify potential conflicts of interest are developed, implemented and monitored.

Where these conflicts cannot be prevented, they should be properly managed (based on the permissibility of relationships or transactions under sound corporate policies consistent with national law and supervisory standards).

82. The board should have a formal written conflicts of interest policy and an objective compliance process for implementing the policy.

The policy should include:

- **a member's duty to avoid to the extent possible activities that could create conflicts of interest or the appearance of conflicts of interest;**

- **examples of where conflicts can arise when serving as a board member;**

- **a rigorous review and approval process for members to follow before they engage in certain activities (such as serving on another board) so as to ensure that such activity will not create a conflict of interest;**

- **a member's duty to promptly disclose any matter that may result, or has already resulted, in a conflict of interest;**

- **a member's responsibility to abstain from voting on any matter where the member may have a conflict of interest or where the member's objectivity or ability to properly fulfil duties to the bank may be otherwise compromised;**

- **adequate procedures for transactions with related parties so that they be made on an arm's length basis; and**

- **the way in which the board will deal with any non-compliance with the policy.**

83. The board should ensure that appropriate public disclosure is made, and/or information is provided to supervisors, relating to the bank's policies on conflicts of interest and potential material conflicts of interest.

84. This should include information on the bank's approach to disclosing and managing material conflicts of interest that are not consistent with such policies, and conflicts that could arise because of the bank's affiliation or transactions with other entities within the group.

85. There is a potential conflict of interest where a bank is both owned by the state and subject to banking supervision by the state.

If such conflicts of interest do exist, there should be full administrative separation of the ownership and banking supervision functions in order to minimise political interference in the supervision of the bank.

Principle 4: Senior management

Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, incentive compensation and other policies approved by the board.

86. Senior management consists of a core group of individuals who are responsible and accountable to the board for effectively overseeing the day-to-day management of the bank.

87. The organisation and procedures and decision-making of senior management should be clear and transparent and designed to promote effective management of the bank.

This includes clarity on the role and authority of the various positions within senior management, including the CEO.

88. Members of senior management should have the necessary experience, competencies and integrity to manage the businesses and people under their supervision.

They should receive access to regular training to maintain and enhance their competencies and stay up to date on developments relevant to their areas of responsibility.

89. Members of senior management should be selected through an appropriate promotion or recruitment process which takes into account the qualifications required for the position in question.

For those senior management positions for which the board of directors is required to review or select candidates through an interview process, senior management should provide sufficient information to the board.

90. Senior management contributes substantially to a bank's sound corporate governance through personal conduct (eg by helping to set the "tone at the top" along with the board).

Members of senior management should provide adequate oversight of those they manage, and ensure that the bank's activities are consistent with the business strategy, risk appetite and the policies approved by the board.

91. Senior management is responsible for delegating duties to staff and should establish a management structure that promotes accountability and transparency throughout the bank.

92. Senior management should implement, consistent with the direction given by the board, risk management systems, processes and controls for managing the risks – both financial and non-financial – to which the bank is exposed and for complying with laws, regulations and internal policies.

- This includes comprehensive and independent risk management, compliance and audit functions, as well as an effective overall system of internal controls.

- Senior management should recognise and respect the independent duties of the risk management, compliance and internal audit functions and should not interfere in their exercise of such duties.

93. Senior management should provide the board with the information it needs to carry out its responsibilities, supervise senior management and assess the quality of senior management's performance.

In this regard, senior management should keep the board regularly and adequately informed of material matters, including:

- changes in business strategy, risk strategy/risk appetite;

- bank performance and condition;
- breaches of risk limits or compliance rules;
- internal control failures; and
- legal or regulatory concerns.

Principle 5: Governance of group structures

In a group structure, the board of the parent company has the overall responsibility for the group and for ensuring that there is a clear governance framework appropriate to the structure, business and risks of the group and its entities. The board and senior management should know and understand the bank's operational structure and the risks that it poses.

Parent company boards

94. In operating within a group structure, the board of the parent company should be aware of the material risks and issues that might affect both the bank as a whole and its subsidiaries.

It should exercise adequate oversight over subsidiaries while respecting the independent legal and governance responsibilities that might apply to subsidiary boards.

95. In order to fulfil its responsibilities, the board of the parent company should:

- **establish a group structure (including the legal entity and business structure) and a governance framework with clearly defined roles and responsibilities, including those at the parent company level and those at the subsidiary level;**

- **define an appropriate subsidiary board and management structure to contribute to the effective oversight of businesses and subsidiaries,** which takes into account the different risks to which the group, its businesses and its subsidiaries are exposed;

• assess whether the group's corporate governance framework includes adequate policies, processes and controls and addresses risks across the business and legal entity structures;

• ensure the group's corporate governance framework includes appropriate processes and controls to identify and address potential intragroup conflicts of interest, such as those arising from intragroup transactions;

• approve policies and clear strategies for establishing new structures and legal entities, and ensure that they are consistent with the policies and interests of the group;

• assess whether there are effective systems in place to facilitate the exchange of information among the various entities, to manage the risks of the separate entities as well as of the group as a whole, and to ensure effective supervision of the group;

• have sufficient resources to monitor compliance of subsidiaries with all applicable legal, regulatory and governance requirements; and

• maintain an effective relationship with both the home regulator and, through the subsidiary board or direct contact, with the regulators of all subsidiaries.

Subsidiary boards

96. While the strategic objectives, risk governance framework, corporate values and corporate governance principles of the subsidiary bank should align with that of the parent company (referred to here as "group policies"), the subsidiary board should make necessary adjustments where a group policy conflicts with an applicable legal or regulatory provision or prudential rule, or would be detrimental to the sound and prudent management of the subsidiary.

97. In the case of a significant regulated subsidiary (due to its risk profile or systemic importance or due to its size relative to the parent

company), the board of the significant subsidiary should take such further steps as are necessary to help the subsidiary meet its independent corporate governance responsibilities and the legal and regulatory requirements that apply to it.

Complex or opaque structures

98. Banks create structures for legal, regulatory and tax purposes.

Structures can take the form of units, branches, subsidiaries or other legal entities that can considerably increase the complexity of the organisation.

The number of legal entities, and in particular the interconnections and intragroup transactions among such entities, can lead to challenges in identifying and managing the risks of the organisation as a whole.

99. Operating through complex or non-transparent structures may pose financial, legal, reputational and other risks to the bank.

It may impede the ability of the board and senior management to conduct appropriate business oversight and could hinder effective banking supervision.

In addition, the bank may also be indirectly exposed to risk when it performs certain services or establishes structures on behalf of customers.

Examples include acting as a company or partnership formation agent, providing a range of trustee services and developing complex structured finance transactions for customers.

While these activities are often profitable and can serve the legitimate business purposes of customers, customers may in some cases use products and activities provided by banks to engage in illegal or inappropriate activities.

100. Senior management, and the board as appropriate, should be cognisant of these challenges and take appropriate action to avoid or mitigate them by:

• avoiding setting up unnecessarily complicated structures or an inordinate number of legal entities.

• continually maintaining and reviewing appropriate policies, procedures and processes governing the approval and maintenance of those structures or activities, including fully vetting the purpose, the associated risks and the bank's ability to manage those risks prior to setting up new structures and initiating associated activities.

• having a centralised process for approving the creation of new legal entities based on established criteria, including the ability to monitor and fulfil each entity's regulatory, tax, financial reporting, governance and other requirements.

• establishing adequate procedures and processes to identify and manage all material risks arising from these structures, including lack of management transparency, operational risks introduced by interconnected and complex funding structures, intragroup exposures, trapped collateral and counterparty risk.

The bank should only approve structures if the material risks can be properly identified, assessed and managed.

• ensure that the activities and structure are subject to regular internal and external audit reviews.

101. The board of the parent company can enhance the effectiveness of the above efforts by requiring a periodic independent formal review of the structures, their controls and activities, as well as their consistency with board-approved strategy.

102. The board should be prepared to discuss with, and as necessary report to, the bank's supervisor and the host country supervisors the policies and strategies adopted regarding the establishment and maintenance of these structures and activities.

Principle 6: Risk management

Banks should have an effective independent risk management function, under the direction of a Chief Risk Officer (CRO), with sufficient stature, independence, resources and access to the board.

103. The independent risk management function is a key component of the bank's second line of defence.

This function is responsible for overseeing risk-taking activities across the enterprise.

The independent risk management function (bank-wide and within subsidiaries) should have authority within the organisation to oversee the bank's risk management activities.

Key activities of the risk management function should include:

- **identifying material individual, aggregate and emerging risks;**

- **assessing these risks and measuring the bank's exposure to them;**

- **supporting the board in its implementation, review and approval of the enterprise-wide risk governance framework which includes the bank's risk culture, risk appetite, RAS and risk limits;**

- **ongoing monitoring of the risk-taking activities and risk exposures to ensure they are in line with the board-approved risk appetite, risk limits and corresponding capital or liquidity needs (ie capital planning);**

- **establishing an early warning or trigger system for breaches of the bank's risk appetite or limits;**

- **influencing and, when necessary, challenging material risk decisions; and**

- **reporting to senior management and the board or risk committee, as appropriate, on all these items, including but not limited to proposing appropriate risk-mitigating actions.**

104. While it is common for risk managers to work closely with individual business units, the risk management function should be sufficiently independent of the business units and should not be involved in revenue generation.

Such independence is an essential component of an effective risk management function, as is having access to all business lines that have the potential to generate material risk to the bank as well as to relevant risk-bearing subsidiaries and affiliates.

105. The risk management function should have a sufficient number of personnel who possess the requisite experience and qualifications, including market and product knowledge as well as command of risk disciplines.

Staff should have the ability and willingness to effectively challenge business lines regarding all aspects of risk arising from the bank's activities.

Role of the CRO

106. Large, complex and internationally active banks, and other banks, based on their risk profile and local governance requirements, should have a senior manager (CRO or equivalent) with overall responsibility for the bank's risk management function.

In banking groups, there should be a group CRO in addition to subsidiary-level risk officers.

Because some banks may have an officer who fulfils the function of a CRO under a different title, reference in this document to the CRO is intended to incorporate equivalent positions, provided they meet the independence and other requirements set out herein.

107. The CRO has primary responsibility for overseeing the development and implementation of the bank's risk management function.

The CRO is responsible for supporting the board in its development of the bank's risk appetite and RAS and for translating the risk appetite into a risk limits structure.

The CRO, together with management, should be actively engaged in the process of setting risk measures and limits for the various business lines and monitoring their performance relative to risk-taking and limit adherence.

The CRO's responsibilities also include managing and participating in key decision-making processes (eg strategic planning, capital and liquidity planning, new products and services, compensation design and operation).

108. The CRO should have the organisational stature, authority and the necessary skills to oversee the bank's risk management activities.

The CRO should be independent and have duties distinct from other executive functions.

This requires the CRO to have access to any information necessary to perform his or her duties.

The CRO, however, should not have management or financial responsibility related to any operational business lines or revenue-generating functions and there should be no "dual hatting" (ie the chief operating officer, CFO, chief auditor or other senior manager should in principle not also serve as the CRO).

While formal reporting lines may vary across banks, the CRO should report and have direct access to the board or its risk committee without impediment.

The CRO should have the ability to engage with the board and with senior management on key risk issues.

Interaction between the CRO and the board and/or risk committee should occur regularly, and the CRO should have the ability to meet with the board or risk committee without executive directors being present.

109. Appointment, dismissal and other changes to the CRO position should be approved by the board or its risk committee.

If the CRO is removed from his or her position, this should be disclosed publicly.

The bank should also discuss the reasons for such removal with its supervisor.

The CRO's performance, compensation and budget should be reviewed and approved by the risk committee or the board.

Principle 7: Risk identification, monitoring and controlling

Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank's risk management and internal control infrastructure should keep pace with changes to the bank's risk profile, to the external risk landscape and in industry practice.

110. The bank's risk governance framework should include policies, supported by appropriate control procedures and processes, designed to ensure that the bank's risk identification, aggregation, mitigation and monitoring capabilities are commensurate with the bank's size, complexity and risk profile.

111. Risk identification should encompass all material risks to the bank, on- and off-balance sheet and on a group-wide, portfolio-wise and business-line level.

In order to perform effective risk assessments, the board and senior management, including the CRO, should, regularly and on an ad hoc basis, evaluate the risks faced by the bank and its overall risk profile.

The risk assessment process should include ongoing analysis of existing risks as well as the identification of new or emerging risks.

Risks should be captured from all organisational units that originate risk. Concentrations associated with material risks shall likewise be factored into the risk assessment.

112. Risk identification and measurement should include both quantitative and qualitative elements.

Risk measurements should also include qualitative, bank-wide views of risk relative to the bank's external operating environment.

Banks should also have a method to identify and measure hard-to-quantify risks, such as reputation risk.

113. Internal controls are designed, among other things, to ensure that each key risk has a policy, process or other measure, as well as a control to ensure that such policy, process or other measure is being applied and works as intended.

As such, internal controls help ensure process integrity, compliance and effectiveness.

Internal controls provide reasonable assurance that financial and management information is reliable, timely and complete and that the bank is in compliance with its various policies and applicable laws and regulations.

114. In order to avoid actions beyond the authority of the individual or even fraud, internal controls also place reasonable checks on managerial and employee discretion.

Even in smaller banks, for example, key management decisions should be taken by more than one person.

Internal reviews should also determine the extent of a bank's compliance with company policies and procedures, as well as with legal and regulatory policies.

Adequate escalation procedures are a key element of the internal control system.

115. The sophistication of the bank's risk management infrastructure including, in particular, a sufficiently robust data, data architecture and information technology infrastructure – should keep pace with developments such as balance sheet and revenue growth; increasing complexity of the bank's business, risk configuration or operating structure; geographic expansion; mergers and acquisitions; or the introduction of new products or business lines.

116. Banks must have accurate internal and external data to identify and assess risk, make strategic business decisions and determine capital and liquidity adequacy.

The board and senior management should give special attention to the quality, completeness and accuracy of the data used to make risk decisions.

While tools such as external credit ratings or externally purchased risk models and data can be useful as inputs into a more comprehensive assessment, banks ultimately are responsible for the assessment of their risks.

117. Risk measurement and modelling techniques should be used in addition to, but should not replace, qualitative risk analysis and monitoring.

The risk management function should keep the board and senior management apprised of the assumptions used in and potential shortcomings of the bank's risk models and analyses.

This helps ensure more complete and accurate reflection of exposures and may allow quicker action to address and mitigate risks.

118. As part of its quantitative and qualitative analysis, the bank should utilise stress tests and scenario analyses to better understand potential risk exposures under a variety of adverse circumstances.

- Internal stress tests should cover a range of scenarios based on reasonable assumptions regarding dependencies and correlations.

Senior management and, as applicable, the board should review and approve the scenarios that are used in the bank's risk analyses.

- **Stress test programme results should be periodically reviewed with the board or its risk committee.**

Test results should be incorporated into the reviews of the risk appetite, the capital adequacy assessment process, the capital and liquidity planning processes, and budgets.

They should also be linked to recovery and resolution planning.

The risk management function should suggest if and what action is required based on results.

- **The results of stress tests and scenario analyses should also be communicated to, and given appropriate consideration by, relevant business lines and individuals within the bank.**

119. Banks should regularly compare actual performance against risk estimates (ie backtesting) to assist in judging the accuracy and effectiveness of the risk management process and making necessary adjustments.

120. In addition to identifying and measuring risk exposures, the risk management function should evaluate possible ways to mitigate these exposures.

In some cases, the risk management function may direct that risk be reduced or hedged to limit exposure.

In other cases, such as when there is a decision to accept or take risk that is beyond risk limits (ie on a temporary basis) or take risk that cannot be hedged or mitigated, the risk management function should report and monitor the positions to ensure that they remain within the bank's framework of limits and controls or within exception approval.

Either approach may be appropriate depending on the issue at hand, provided that the independence of the risk management function is not compromised.

121. Banks should have risk management and approval processes for new or expanded products or services, lines of business and markets, as well as for large and complex transactions that require significant use of resources or have hard-to-quantify risks.

Banks should also have review and approval processes for outsourcing bank functions to third parties.

The risk management function should provide input on risks as part of such processes and on the outsourcer's ability to manage risks and comply with legal and regulatory obligations.

Such processes should include:

- A full and frank assessment of risks under a variety of scenarios, as well as an assessment of potential shortcomings in the ability of the bank's risk management and internal controls to effectively manage associated risks.

- An assessment of the extent to which the bank's risk management, legal and regulatory compliance, information technology, business line and internal control functions have adequate tools and the expertise necessary to measure and manage related risks.

- If adequate risk management processes are not in place, a new product, service, business line or third-party relationship or major transaction should be delayed until the bank is able to appropriately address the activity.

- There should also be a process to assess risk and performance relative to initial projections and to adapt the risk management treatment accordingly as the business matures.

122. Effective risk identification and measurement approaches are likewise necessary in subsidiary banks and affiliates.

Material risk-bearing affiliates and subsidiaries should be captured by the bank- wide risk management system and should be a part of the overall risk governance framework.

123. Subsidiary boards and senior management remain responsible for developing effective risk management processes for their entities.

The methods and procedures applied by subsidiaries should support the effectiveness of risk management at a group level.

While parent companies should conduct strategic, group-wide risk management and prescribe corporate risk policies, subsidiary management and boards should have appropriate input to their local or regional application and to the assessment of local risks.

Parent companies should ensure that adequate tools and authorities are available to the subsidiary and that the subsidiary understands what reporting obligations it has to the head office.

124. Mergers and acquisitions, divestitures and other changes to a bank's organisational structure can pose special risk management challenges to the bank. In particular, risks can arise from conducting insufficient due diligence that fails to identify post-merger risks or activities conflicting with the bank's strategic objectives or risk appetite.

The risk management function should be actively involved in assessing risks that could arise from mergers and acquisitions and report its findings directly to the board or its risk committee.

Principle 8: Risk communication

An effective risk governance framework requires robust communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

125. Ongoing communication about risk issues, including the bank's risk strategy, throughout the bank is a key tenet of a strong risk culture.

A strong risk culture should promote risk awareness and encourage open communication and challenge about risk-taking across the organisation as well as vertically to and from the board and senior management.

Senior management should keep control functions informed of management's major plans and activities so that the control functions can properly assess the risks.

126. Information should be communicated to the board and senior management in a timely, accurate and understandable manner so that they are equipped to take informed decisions.

While ensuring that the board and senior management are sufficiently informed, management and those responsible for the risk management function should avoid voluminous information that can make it difficult to identify key issues.

Rather, information should be prioritised and presented in a concise, fully contextualised manner.

The board should institute periodic reviews of the relevance and accuracy of information it receives and determine if additional information is needed.

127. Material risk-related ad hoc information that requires immediate decisions or reactions should be promptly presented to senior management and the board, the responsible officers and, where applicable, the heads of control functions, so that suitable measures and activities can be initiated at an early stage.

Suitable policies and procedures should be established for this purpose.

128. Risk reporting to the board requires careful design in order to ensure that bank-wide, individual portfolio and other risks are conveyed in a concise and meaningful manner.

Reporting should accurately communicate risk exposures and results of stress tests or scenario analyses and should provoke a robust discussion of, for example, the bank's current and prospective exposures (particularly under stressed scenarios), risk/return relationships and risk appetite and limits.

Reporting should also include information about the external environment to identify market conditions and trends that may have an impact on the bank's current or future risk profile.

129. Risk reporting systems should be dynamic, comprehensive and accurate, and should draw on a range of underlying assumptions.

Risk monitoring and reporting should not only occur at the disaggregated level (including risk residing in subsidiaries that could be considered significant), but should also be aggregated to allow for a bank-wide or integrated perspective of risk exposures.

Risk reporting systems should be clear about any deficiencies or limitations in risk estimates, as well as any significant embedded assumptions (eg regarding risk dependencies or correlations).

130. Banks should avoid organisational "silos" that can impede effective sharing of information across an organisation and can result in decisions being taken in isolation from the rest of the bank.25 Overcoming these information-sharing obstacles may require the board, senior management and control functions to re-evaluate established practices in order to encourage greater communication.

Principle 9: Compliance

The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should approve the bank's compliance approach and policies, including the establishment of a permanent compliance function.

131. An independent compliance function is a key component of the bank's second line of defence.

This function is responsible, among other things, for promoting and monitoring that the bank operates with integrity and in compliance with applicable, laws, regulations and internal policies.

132. Compliance starts at the top. It will be most effective in a corporate culture that emphasises standards of honesty and integrity and in which the board of directors and senior management lead by example.

It concerns everyone within the bank and should be viewed as an integral part of the bank's business activities.
A bank should hold itself to high standards when carrying out its business and should at all times strive to observe the spirit as well as the letter of the law.

Failure to consider the impact of its actions on its shareholders, customers, employees and the markets may result in significant adverse publicity and reputational damage, even if no law has been broken.

133. The bank's senior management is responsible for establishing a written compliance approach and policies that contain the basic principles to be followed by the board, management and staff, and explains the main processes by which compliance risks are to be identified and managed through all levels of the organisation.

Clarity and transparency may be promoted by making a distinction between general standards for all staff members and rules that only apply to specific groups of staff.

134. While the board and management are accountable for the bank's compliance, the compliance function has an important role in supporting corporate values, policies and processes that help ensure that the bank acts responsibly and observes all obligations applicable to it.

135. The compliance function should advise the board and senior management on compliance laws, rules and standards, including keeping them informed of developments in the area.

It should also help educate staff about compliance issues, act as a contact point within the bank for compliance queries from staff members, and provide guidance to staff on the appropriate implementation of compliance laws, rules and standards in the form of policies and procedures and other documents such as compliance manuals, internal codes of conduct and practice guidelines.

136. The compliance function is independent from management and provides separate reporting to the board on the bank's efforts in the above areas and on how the bank is managing its compliance risk.

137. To be effective, the compliance function must have sufficient authority, stature, independence, resources and access to the board. Management should respect the independent duties of the compliance function and not interfere with them.

138. The areas of special focus by the compliance function include those that could create reputational risk for the bank, including bribery, money laundering, country sanctions, fair treatment of the consumer and practices raising ethical issues.

Principle 10: Internal audit

The internal audit function provides independent assurance to the board and supports board and senior management in promoting an effective governance process and the long-term soundness of the bank. The internal audit function should have a clear mandate, be accountable to the board, be independent of the audited activities and have sufficient standing, skills, resources and authority within the bank.

139. The board and senior management should recognise and acknowledge that an independent and qualified internal audit function is vital to an effective governance process.

140. An effective internal audit function provides an independent assurance to the board of directors and senior management on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes, thereby helping the board and senior management protect their organisation and its reputation.

141. The internal audit function should be accountable to the board on all matters related to the performance of its mandate as described in the internal audit charter.

It must be independent of the audited activities and have sufficient standing, authority and resources within the bank to enable the auditors to carry out their assignments effectively and objectively.

142. The board and senior management can enhance the effectiveness of the internal audit function by:

- requiring the function to independently assess the effectiveness and efficiency of the internal control, risk management and governance systems and processes;

- requiring internal auditors to adhere to national and international professional standards, such as those established by the Institute of Internal Auditors; and

- ensuring that audit staff have skills and resources commensurate with the business activities and risks of the bank.

143. The board and senior management should respect and promote the independence of the internal audit function by, for example:

- ensuring that internal audit reports are provided to the board without management filtering and that the internal auditors have direct access to the board or the board's audit committee.

- requiring timely and effective correction of audit issues by senior management.

- requiring a periodic assessment of the bank's overall risk governance framework including, but not limited to, an assessment of:

o the effectiveness of the risk management and compliance functions;

o the quality of risk reporting to the board and senior management; and

o the effectiveness of the bank's system of internal controls.

Principle 11: Compensation

The bank's compensation structure should be effectively aligned with sound risk management and should promote long term health of the organisation and appropriate risk-taking behaviour.

144. Compensation systems form a key component of the governance and incentive structure through which the board and senior management promote good performance, convey acceptable risk- taking behaviour and reinforce the bank's operating and risk culture.

The board is responsible for the overall oversight of the compensation system for the entire bank.

In addition, the board should regularly monitor and review outcomes to ensure that the bank-wide compensation system is operating as intended.

The board should review the compensation policy at least annually.

145. The FSB principles on compensation are intended to apply to significant financial institutions but they are especially critical for large, systemically important firms.

National jurisdictions may also apply the principles in a proportionate manner to smaller, less complex institutions.

Banks are encouraged to implement the FSB principles, or consistent national provisions based on them.

146. The board should approve the compensation of senior executives, including the CEO, CRO and the head of internal audit, and should oversee management's development and operation of compensation policies, systems and related control processes.

147. Significant financial institutions should have a board remuneration committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation on behalf of the board of directors.

The remuneration committee should be constituted in a way that enables it to exercise competent and independent judgment on compensation policies and practices and the incentives created for managing risk, capital and liquidity.

148. For employees in risk, compliance and other control functions, compensation should be determined independently of any business line overseen, and performance measures should be based principally on the achievement of their own objectives so as not to compromise their independence.

149. The compensation structure should promote long term performance and be in line with the business and risk strategy, objectives, values and long-term interests of the bank and incorporate measures to prevent conflicts of interests.

Compensation programmes should facilitate adherence to risk appetite, promote appropriate risk-taking behaviour and encourage employees to act in the interest of the company as a whole (also taking into account client interests) rather than for themselves or only their business lines.

150. Practices by which compensation is paid for potential future revenues whose timing and likelihood remain uncertain should be carefully evaluated by means of both qualitative and quantitative key indicators.

Banks should ensure that variable compensation is adjusted to take into account the full range of current and potential risks an employee takes as well as realised risks, including breaches of internal procedures or legal requirements.

Compensation should reflect risk-taking and risk outcomes.

151. Compensation payout schedules should be sensitive to risk outcomes over a multi-year horizon.

This is often achieved through arrangements that defer a sufficiently large part of the compensation for a sufficiently long period of time until risk outcomes become better known.

This includes "malus/forfeiture" provisions (where compensation can be reduced or reversed based on realised risks or conduct events before compensation vests) and/or "clawback" provisions under which compensation can be reduced or reversed after compensation vests if new facts emerge that the compensation paid was based on erroneous assumptions (such as misreporting) or if it is discovered that the employee has failed to comply with internal policies or legal requirements.

"Golden hellos" or "golden parachutes" under which new or terminated executives or staff receive large payouts irrespective of performance are generally not consistent with sound compensation practice.

Principle 12: Disclosure and transparency

The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

152. Transparency is consistent with sound and effective corporate governance.

As emphasised in existing Committee guidance on bank transparency, it is difficult for shareholders, depositors, other relevant stakeholders and market participants to effectively monitor and properly hold the board and senior management accountable when there is insufficient transparency.

The objective of transparency in the area of corporate governance is therefore to provide these parties with the information necessary to enable them to assess the effectiveness of the board and senior management in governing the bank.

153. Although disclosure may be less detailed for non-listed banks, especially those that are wholly owned, these banks can nevertheless pose the same types of risk to the financial system as publicly traded banks through various activities, including their participation in payment systems and acceptance of retail deposits.

154. All banks, even those for whom disclosure requirements may differ because they are non-listed, should disclose relevant and useful information that supports the key areas of corporate governance identified by the Committee.
Such disclosure should be proportionate to the size, complexity, structure, economic significance and risk profile of the bank.

At a minimum, banks should disclose annually the following information:

- the recruitment approach for the selection of members of the board and their knowledge, skills and expertise;

- the policy for ensuring board membership that represents appropriate diverse views, its objectives and the extent to which these objectives have been achieved; and

- whether the bank has set up board committees and the number of times these committees have met.

155. In general, the bank should apply the disclosure and transparency section of the OECD principles.

Accordingly, disclosure should include, but not be limited to, material information on the bank's objectives, organisational and governance structures and policies (in particular the content of any corporate governance or remuneration code or policy and the process by which it is implemented), major share ownership and voting rights and related party transactions.

Relevant banks should appropriately disclose their incentive and compensation policy following the FSB principles related to compensation.

In particular, an annual report on compensation should be disclosed to the public.

It should include: the decision-making process used to determine the bank-wide compensation policy; the most important design characteristics of the compensation system, including the criteria used for

performance measurement and risk adjustment; and aggregate quantitative information on compensation.

156. The bank should also disclose key points concerning its risk exposures and risk management strategies without breaching necessary confidentiality.

When involved in complex or non-transparent activities, the bank should disclose adequate information on their purpose, strategies, structures, and related risks and controls.

157. Disclosure should be accurate, clear and presented such that shareholders, depositors, other relevant stakeholders and market participants can consult the information easily.

Timely public disclosure is desirable on a bank's public website, in its annual and periodic financial reports, or by other appropriate means.

It is good practice to have an annual corporate governance-specific and comprehensive statement in a clearly identifiable section of the annual report depending on the applicable financial reporting framework.

All material developments that arise between regular reports should be disclosed to the bank supervisor and relevant stakeholders as required by law without undue delay.

Principle 13: The role of supervisors

Supervisors should provide guidance for and supervise corporate governance at banks, including through comprehensive evaluations and regular interaction with boards and senior management, should require improvement and remedial action as necessary, and should share information on corporate governance with other supervisors.

158. The board and senior management are primarily responsible for the governance of the bank, and shareholders and supervisors should hold them accountable for this.

This section sets forth several principles that can assist supervisors in assessing corporate governance and fostering good corporate governance in banks.

Guidance on expectations for sound corporate governance

159. Supervisors should establish guidance or rules, consistent with the principles set forth in this document, requiring banks to have robust corporate governance policies and practices.

Such guidance is especially important where national laws, regulations, codes or listing requirements regarding corporate governance are too generic or not sufficient to address the unique corporate governance needs of banks.

Regulatory guidance should address, among other things, expectations for checks and balances and a clear allocation of responsibilities, accountability and transparency among the board and senior management and within the bank.

In addition to guidance or rules, where appropriate, supervisors should also share industry best practices regarding corporate governance with the banks they supervise.

Comprehensive evaluations of a bank's corporate governance

160. Supervisors should have processes in place to fully evaluate a bank's corporate governance.

Such evaluations may be conducted through regular reviews of written materials and reports, interviews with board members and bank personnel, examinations, self-assessments by the bank, and other types of on- and off-site monitoring.

The evaluations should also include regular communication with a bank's board of directors, senior management and those responsible for the risk, compliance and internal audit functions and external auditors.

161. Supervisors should evaluate whether the bank has in place effective mechanisms through which the board and senior management execute their respective oversight responsibilities.

Supervisors should evaluate whether the board and senior management have processes in place for the oversight of the bank's strategic objectives including risk appetite, financial performance, capital adequacy, capital planning, liquidity, risk profile and risk culture, controls, compensation practices, and the selection and evaluation of management. Supervisors should focus particular attention on the oversight of the risk management, compliance and internal audit functions.

This should include assessing the extent to which the board interacts with and meets with representatives of these functions. Supervisors should determine whether internal controls are being adequately assessed and contribute to sound governance throughout the bank.

162. Supervisors should evaluate the processes and criteria used by banks in the selection of board members and senior management and, as they judge necessary, obtain information about the expertise and character of board members and senior management.

The fit and proper criteria should include those discussed in Principle 2 of this document.

The individual and collective suitability of board members and senior management should be subject to ongoing attention by supervisors.

163. As part of their evaluation of the overall corporate governance in a bank, supervisors should also endeavour to assess the governance effectiveness of the board and senior management, especially with respect to the risk culture of the bank.

An assessment of governance effectiveness aims to determine the extent to which the board and senior management demonstrate effective behaviours that contribute to good governance.

This includes consideration of the behavioural dynamic of the board and senior management, such as how the "tone at the top" and the cultural values of the bank are communicated and put into practice, how information flows to and from the board and senior management, and how potential serious problems are identified and addressed throughout the organisation.

The evaluation of governance effectiveness includes review of any board and management assessments, surveys and other information often used by banks in assessing their internal culture, as well as supervisory observations and qualitative judgments.

In arriving at such judgments, supervisors need to be particularly mindful of consistency of treatment across the banks they supervise and ensure that staff have appropriate training and competence in these areas.

164. In reviewing corporate governance in the context of a group structure, supervisors should take into account the corporate governance responsibilities of both the parent company and subsidiaries, in accordance with Principle 5 of this document.

Regular interaction with directors and senior management

165. Supervisors should interact regularly with boards of directors, individual board members, senior managers and those responsible for the risk management, compliance and internal audit functions.

This should include scheduled meetings and ad hoc exchanges, through a variety of communication vehicles (eg e-mail, telephone, in-person meetings).

The purpose of the interactions is to support timely and open dialogue between the bank and supervisors on a range of issues, including the bank's strategies, business model and risks, the effectiveness of corporate governance at the bank, the bank's culture, management issues and succession planning, compensation and incentives, and other supervisory concerns or expectations.

Supervisors may also provide insights to the bank on its operations relative to its peers, market developments and emerging systemic risks.

166. The frequency of interactions with the above persons may vary according to the size, complexity, structure, economic significance and risk profile of the bank.

On that basis, supervisors may, for example, meet with the full board of directors annually, but more frequently with the chairman or lead or senior independent director and with key committee chairs.

For systemically important banks, interaction should occur more frequently, particularly with members of the board and members of senior management, and those responsible for risk management, compliance and internal audit functions.

Requiring improvement and remedial action by a bank

167. Supervisors should have a range of tools at their disposal to address governance improvement needs and governance failures.

They should be able to require improvement steps and remedial action, and assure accountability for the corporate governance of a bank.

These tools may include the ability to compel changes in the bank's policies and practices, the composition of the board of directors or senior management, or other corrective actions.

They should also include, where necessary, the authority to impose sanctions or other punitive measures.

The choice of tool and the time frame for any remedial action should be proportionate to the level of risk the deficiency poses to the safety and soundness of the bank or the relevant financial system(s).

168. When a supervisor requires a bank to take remedial action, the supervisor should set a timetable for completion.

Supervisors should have escalation procedures in place to require more stringent or accelerated remedial action in the event that a bank does not adequately address the deficiencies identified or the supervisor deems that further action is warranted.

Cooperation and sharing of corporate governance information with other relevant supervisors

169. Cooperation and appropriate information-sharing among relevant public authorities, including bank supervisors, can significantly contribute to the effectiveness of these authorities in their respective roles. Such information-sharing is particularly important between home and host supervisors of cross- border banking entities.

Cooperation can occur on a bilateral basis, in the form of a supervisory college or through periodic meetings among supervisors at which corporate governance matters should be discussed.

Such communication can help supervisors improve their assessment of the overall governance of a bank and the risks it faces, particularly in a group context, and help other authorities assess the risks posed to the broader financial system.

Information shared should be relevant for supervisory purposes and be provided within the constraints of confidentiality and other applicable laws.

Special arrangements, such as a memorandum of understanding, may be warranted to govern the sharing of information among supervisors or between supervisors and other authorities.

Speech at the Lord Mayor's Banquet

Speech by Mr Andrew Bailey, Deputy Governor of Prudential Regulation and Chief Executive Officer of the Prudential Regulation Authority at the Bank of England, at the City Banquet, London

Lord Mayor, thank you once again for inviting us round to Dinner.

Events at the Mansion House never cease to be special, with an aura that sets them apart.

It is a true story from some years ago that a very senior official from another country came to a lunch at the Mansion House, at which he spoke, and after which he came to visit the then Governor of the Bank.

He had been impressed by the grandeur of the surroundings, the food and drink, the speeches (in plural), but he had just one question for the Governor.

How does anyone make money in the City if that is how they carry on?

The Governor was wise and slightly avuncular in his answer, to the point of remarking that it is not a question that anyone in the City would ask.

Lunches may have become shorter, but dinners remain a place to take stock over good food and wine and with good company.

And, for Martin and me it is a chance to take stock after just over eighteen months of the new arrangements.

The PRA is responsible for the prudential supervision of banks, insurers and major investment firms.
We take all of our responsibilities very seriously, as of course we should.

Across the board, there have been developments over the last year that give me a sense of cautious satisfaction - by the way, that is at the happier end of the spectrum of emotions for a central banker

Seriously, I am afraid that we must not get carried away here.

We are in many ways in the second phase of the financial crisis.

The first phase was a prudential one, while the second phase has revealed past misconduct.

Fixing the financial system requires more than just fixing capital and liquidity standards.

Standards of governance, conduct and the right incentives structures are all extremely important.

After commenting on two material development this year I want to use the rest of my time to set out four areas where we are either taking action, or watching very carefully to determine whether action may be required.

Let me start by describing two developments which point to some cautious satisfaction.

First, the capital position of UK banks has strengthened.

Market conditions have supported actions to raise capital and reduce non-core assets, and banks have taken advantage of those conditions.

The targets that were set as a consequence of the FPC and PRA exercise of nearly two years ago have been met ahead of schedule.

The banking system is now more able to support lending and the growth of the economy.

I will repeat something that I have said often before, namely that a well-capitalised banking system is essential to support the economy. No good comes from having a fragile system.

The evidence from the Bank of England's regional agents through their contacts with borrowers among companies is that there is more lending on offer but companies are reluctant and wary about banks, and this picture is consistent with the economy wide figures.

Given the evidence of revealed misconduct, we should sadly not be surprised at this wariness, but neither can we be relaxed about it.

My second important development comes in the field of life insurance.

Insurance as a whole is a vital industry to all of us, performing the essential function of enabling us to manage our risks.

Within the insurance industry, life firms provide access to retirement income and long-term savings as well as financial protection against mortality.

Earlier this year the Government made a major announcement on annuities, which are an important part of retirement provisions.

Like many people, this struck me as a sensible announcement, pointing to a clear need for change.

The big question of course, is what next - or if not that, what else? We heard something on that earlier this week.

I am not going to reflect on that tonight, but while the original announcement came as a shock to some business models, the PRA's assessment was that it did not appear to compromise the safety and soundness of firms in way that threatens our objective, and nor did it threaten our insurance objective of policyholder protection.

No firm has failed, but bear in mind that orderly failure is very much consistent with our objectives being met.
That is what should happen in my view, namely the prudential position should be sufficiently safe and sound to accommodate changes in other areas of public policy.

It is not easy in our world to point to indications of when our objectives are met, a point made to us quite rightly by the National Audit Office.

I would offer this as one such indicator.

I will spend the rest of my time commenting on a four areas where we are either taking action or watching very carefully to determine whether action may be required.

The first is the capital framework for banks - which is distinct from, but related to, the capital position of banks that I mentioned at the start.

There are now three planks to the capital framework: a risk-based assessment which may be based either around firms' internal models or a standardised approach; a measurement of leverage; and stress tests.

Together these approaches provide firms and us with the tools to do two things: to add up overall capital requirements; and as diagnostic tools to allow the probing and analysis of strengths and weaknesses of firms' positions.

I cannot emphasise enough that good judgemental supervision which is forward-looking employs diagnostic tools.

None of these tools will provide the "right" answer, they are not tablets of stone.

They enable assessment and challenge, by managements, boards and supervisors.

The idea that we could rely on one of these tools alone, which you can read in some books, is, let me be blunt, naïve.

Good supervision looks at things from different angles in order to build up pictures.

In the same vein, I do not agree with those who say that we should disallow firms' internal models.

That amounts to saying we are not interested in how firms' manage their own risks and that somehow we have better models to use.

But, we don't rely exclusively on firms' models, and we challenge them hard; and we throw them out when we don't like them, and we have done that.

Good prudential supervisors are bold enough to do that.

The lesson is look at models, but do it properly, and to do that is not a simple job.

Toward the end of the year, we will publish the results of our first round of simultaneous across major UK banks stress tests, which will follow the publication by the European Banking Authority of its stress tests in just over a week from now.

Our stress tests are a real step in the direction towards the full use of such tests as one of the three pillars of the capital framework.

This is a major development compared to the cumbersome and slow process of stress testing one bank after another that we developed during and after the height of the crisis.

We will be using these tests to assess whether firms have capital positions and capital plans looking forwards which will provide re-assurance that they will be safe and sound under stressed conditions, as the name suggests.

If they don't - and you should take no inference on the results from what I say here - we will ask them to look again at their plans.

Stress tests should not be a dramatic event, they should be part of the health check and they should prompt measured responses where necessary, and reflecting the fact that at different speeds banks are heading out of the crisis.

Last on capital is the issue of loss absorbency in going and gone concern states.

For the major banks this is the too big to fail problem.

The Basel Capital framework was flawed: it didn't provide adequate loss absorbency in going concern; and it failed to consider what would happen in gone concern states of the world.

The global framework remains in that position until we can get agreement on, and implementation of, a Total Loss Absorbency framework.

This is our single most important objective, at the heart of the global work of the FSB in respect of the largest banks - the globally significant.

The huge effort to secure what will be an historic agreement comes to the table in Brisbane next month.

I'm not going to tempt fate; but my fingers are crossed, and I should add that this is the nearest I get to insider trading, as I know the impressive quality of the work that has gone on in the FSB.

The second area on which I will comment concerns the insurance industry, namely the introduction of Solvency II.

It will happen in 2016.

It is a major step forward as a framework for risk assessment.

It is not the first time that insurance firms will be using models to assess safety and soundness and policyholder protection.

That would be an absurd thing to say for an industry that has modelled from the outset.

But, it does represent a step change in the use of models in the prudential process.

Very briefly I want to be clear that we will be using these models in an appropriately diagnostic fashion.

None of us should be slaves to models.

We will challenge robustly, and some of our challenges will be less welcome than others, that is the nature of what we do.

As Mark Carney said recently, this rigour has a purpose.

The dangers of using poorly designed models were made all too clear in the banking sector.

So the PRA won't hesitate to withhold approval of an inadequate or opaque model.

But, I want to give a commitment from the PRA, my door will always be open to discuss the challenges, and the same goes for my colleagues.

My third area might at first hearing sound rather odd as it is conduct risk or, sadly, misconduct risk.

No, I am not making a bid for the FCA - I like Twin Peaks thank you; and the PRA and the FCA work together, and Martin and I put great emphasis on that happening.

But as I said earlier we are in many ways in the second phase of the financial crisis, and this phase has at its root conduct of business, towards customers, in financial markets, and in areas of public policy such as financial sanctions and anti-money laundering.

At its most serious, this confluence of conduct risk can threaten the safety and soundness of firms.

Let me be clear, as a prudential supervisor I do not condone misconduct, and I support Martin and the FCA in what they are doing.

Society expects higher standards, and the PRA supports the FCA in upholding these standards as part of the global effort to restore trust between financial institutions, regulators and - most importantly - the public.

Three things strike me as important as part of this effort and I pick these three because they are close to my role and that of the PRA and the wider Bank of England.

First, the Fair and Effective Markets Review under my colleague Minouche Shafik, with Martin and Charles Roxburgh, is vitally important to establish the better standards that society reasonably expects.

Second, we need better international coordination among authorities to enable conduct risks to be dealt with effectively, but also in ways that do not threaten safety and soundness.

That is a high priority.

And third, to support credit and borrowing in the economy, and thus growth, we must all work to ensure that people feel confident to use banks and thus overcome the legacy of mistrust from revealed misconduct.

The fourth issue on which I want to comment concerns incentives.

These lie at the heart of good pro-active supervision, getting the incentives right.

Unfortunately, we see areas where that has not happened.
I want to cover two of those.

The first is remuneration.

Once again there is a lot being said on this subject.

My view has not changed.

We need a system where senior people who are responsible for the performance of their firms understand that for a reasonable period of time a meaningful proportion of their remuneration is at risk of being taken away.

There is nothing new about this; after all, it is how the traditional partnership system worked.

So let me be blunt, the bonus cap is the wrong policy, the debate around it is misguided, and the best thing I can say about allowances is that they are a response to a bad policy.

They are not a good solution.

I will not win friends in some places for saying this but it dismays me to see a debate which is at times so divorced from the heart of the matter, which is setting appropriate incentives by putting a meaningful amount of pay at risk.

Sadly, taking this stance sometimes attracts the criticism of being pro bonuses.

This is not true, and I can say from experience that advocating putting bankers' pay at risk does not naturally improve my popularity in some quarters.

But if you don't believe it from me, here is what the Parliamentary Commission on Banking Standard had to say: "There are distinct advantages to a significant proportion of banking remuneration being in variable rather than fixed form.

It is easier to adjust variable remuneration to reflect the health of an individual bank.

The use of variable remuneration also allows for deferral and the recouping of rewards in ways which better align remuneration with the longer term interests of a bank".

The second area where incentives are important is governance of firms.

For banks, Parliament has legislated to introduce the Senior Managers regime which implements an important recommendation of the Parliamentary Commission on Banking Standards, and the PRA and FCA are consulting on our proposals for implementation.

For insurers, we will consult on implementing the fit and proper requirements of Solvency II, and as the Governor has made clear it is our view that we should align the regimes where that is possible.

I have read with considerable interest some of the press reporting of the new regime, which has been at times at odds with the facts.

The regime has been portrayed as all about proving criminality under a reverse burden of proof.

That is the wrong interpretation.

The key principle is a simple one: there should be a presumption of senior management responsibility.

To support that principle, we will set out the meaning of the statutory requirement that senior managers will need to show that they have taken the steps that a person in their position could reasonably be expected to take to prevent breaches of our requirements.

We are very clear on the presumption of responsibility, as Mark Carney has said, but I would assert that the test is no different from other areas of corporate responsibility.

In this context senior management means only the very senior executives, and in the PRA's proposals, only non-executives that are either: the chair; chair of a major board committees; or the senior independent director.

There are differences between prudential and conduct in this respect, and our consultation poses the question of how substantial those differences should be.

But, is it really unreasonable to expect the most senior figures to assume responsibility?

Not in my view, and in my experience not in the view of those who take on these roles.

Boards should challenge and this is the role of the NEDS.

The executive should view this as a positive help to improving judgements the board is called upon to make and so should provide NEDs with the material to do that, and to do so as concisely as possible.

The old saying for students that it is harder to write a good short essay than a long one is relevant here. And, as supervisors we too should follow that principle.

In conclusion, whilst more capital and liquidity was a necessary condition for fixing the financial system, it wasn't sufficient.

Getting the incentives and governance right matters a lot.

As supervisors our job requires good judgement - not easy but it has to be done - and it also requires a keen eye for structuring incentives to deliver our objectives.

Rules alone will not get us there.

Lord Mayor, you are a great example to all of us who want to improve the diversity of our institutions, which makes them better places to work in.

You are going on to undertake a role of great importance, one that reminds us that whatever the problems that we deal with, there are unthinkable acts of evil taking place.

It reminds us not be become obsessed with our own work to the exclusion of the terrible human suffering that can happen.

We wish you all the best in your future role, and please accept our thanks for all that you have done and are doing as Lord Mayor.

effective information sharing that all jurisdictions, including non-CMG hosts, have in place an adequate regime for the protection of confidential information that imposes adequate confidentiality requirements.

1. Purpose

1.1 The purpose of this note is to provide guidance on cooperation and information sharing between CMGs and non-CMG host jurisdictions.

It is addressed to home authorities and CMGs of G-SIFIs, and non-CMG host authorities of G-SIFIs and covers:

(i) processes for identifying jurisdictions where operations of a G-SIFI are locally systemic (Section 2);

(ii) criteria for assessing a systemic G-SIFI presence in a non-CMG host jurisdiction (Section 3);

(iii) possible cooperation and information sharing arrangements with a non-CMG host jurisdiction (Section 4); and

(iv) classes of information that should be shared (Section 5).

1.2 The requirements in the Key Attributes for cooperation with CMGs and non-CMG host authorities apply to G-SIFIs generally.

However some considerations in this guidance may be applicable only to global systemically important banks (G-SIBs).

2. Process for identifying non-CMG host jurisdictions

2.1 The process for identifying non-CMG host jurisdictions where the G-SIFI has a systemic presence should begin as soon as practicable after a CMG is established.

2.2 Non-CMG host authorities should be best placed to assess the systemic importance of a G-SIFI's local operations in their own jurisdictions.

Non-CMG host authorities should submit their assessment of systemic importance to home authorities.

Non- CMG host authorities should also provide sufficient information to home authorities to enable the home authorities to ascertain the reasons for the host authorities' assessment.

2.3 Home authorities should also take measures to identify the non-CMG host jurisdictions where the G-SIFI has a systemic presence.

They may, as appropriate, consult other members of the CMG. They should be able to obtain from the G-SIFI the relevant information that is necessary to support an analysis of those jurisdictions where its operations are deemed locally systemic.

2.4 Once the home authorities have identified non-CMG host jurisdictions with locally systemic operations or have received an assessment of systemic importance of a G- SIFI's local operations from a non-CMG host jurisdiction, it should engage with the relevant authorities in those jurisdictions to review that initial identification.

2.5 In the event of any discrepancies between the assessments of the home authorities and the non-CMG host authorities, both home and non-CMG host authorities should review the reasons for their assessments and address points of divergence (for example, use of different assessment criteria, different weighting of assessment criteria or reliance on different data).

The home authority should generally accept the host authorities' assessment provided it is supported by the criteria described in Section 3.

2.6 Home authorities should share the list of identified non-CMG host jurisdictions within the CMGs and, upon request, with other non-CMG host authorities.

2.7 The determination of non-CMG host jurisdictions should be reviewed regularly (for example annually).

3. Criteria for assessing a systemic G-SIFI presence

3.1 To assess the systemic presence of a G-SIFI's operations in a non-CMG host jurisdiction, home and non-CMG host authorities should assess the potential impact of the failure of the G-SIFI on the host economy having regard to a number of considerations, which include

(i) size;

(ii) interconnectedness;

(iii) substitutability or financial institution infrastructure (including considerations related to the concentrated nature of the banking sector); and

(iv) complexity (including the additional complexities from cross-border activity). In addition, both home and non- CMG host authorities may need to consider other criteria to assess the systemic presence, especially for local G-SIFI branches.

3.2 The use of common assessment criteria may help to promote a consistent approach to the assessment of the systemic presence of G-SIFI operations across non-CMG host jurisdictions. Such criteria may include, but are not limited to, the following.

a. The Basel Committee on Banking Supervision ('BCBS') framework for dealing with domestic systemically important banks ('D-SIBs') ('the BCBS D-SIB Framework').

b. The framework for assessing critical functions set out in the FSB's paper Guidance on Identification of Critical Functions and Critical Shared Services.

Examples of critical functions and characteristics that may render local G-SIFI operations systemically important in a host jurisdiction include payments, custody, certain lending and deposit-taking actives in the commercial or retail sector, clearing and settling, limited segments of wholesale markets, market- making in certain securities and highly concentrated specialist lending sectors.

4. Cooperation and information sharing arrangements

Types of arrangements

4.1 Once it has been determined that a G-SIFI has a systemic presence in a non-CMG host jurisdiction, the home and the non-CMG host authorities, in consultation, as necessary, with members of the CMG, should agree on the arrangements that will address the needs of the non-CMG host authorities, the home authority and CMG for mutual cooperation and information sharing.
4.2 The home authority should engage with non-CMG host authorities and, as appropriate, with members of the CMG in determining a practical cooperation and information sharing arrangement that is tailored and appropriate, taking into account a range of factors, including:

a. the nature of the firm's presence in the non-CMG host jurisdiction (for example, whether it takes the form of a domestically incorporated subsidiary, a branch of a foreign firm or an intermediate holding company of a sub-group);

b. the nature of the firm's group structure (for example, the extent of the financial, managerial and operational dependence of the local operations on the parent firm or its subsidiaries in other jurisdictions);

c. the nature of the activities the firm undertakes (for example, deposit taking and lending, payment services, its role in other financial infrastructure such as facilitating indirect clearing for other firms) and their systemic importance in the non-CMG host jurisdiction;

d. the potential volume and similarity of information needed by the identified non- CMG host jurisdictions;

e. the relevance of the actions (or forbearance) of the non-CMG host authorities in the event of the firm's distress for the implementation of the agreed resolution strategy and operational plan for the whole firm; and

f. the required level of involvement of non-CMG host authorities in implementing the preferred resolution strategy for the G-SIFI.

4.3 Authorities may consider different types of arrangements, which can also be combined in different ways:

a. An 'extended' or 'universal' CMG (based on the model used by supervisory colleges) including all or some host authorities that are not members of the 'core' CMG.

b. One or more regional sub-CMGs for specific geographical areas. This arrangement might be suited to a firm where the group is structured to reflect the geographical distribution of local operations and critical functions. The composition of regional sub-CMGs should take into account group structure and the form of cross-border operations.

c. Bilateral cooperation and information sharing arrangements.

Bilateral arrangements entered into between the home and individual non-CMG host authorities might be suitable where there is a need for direct engagement with non-CMG host authorities and specific reciprocal information needs.

Where appropriate, depending on the type of arrangement, the COAG should set out the processes for information sharing with non-CMG hosts authorities.

4.4 The number of non-CMG host jurisdictions may vary over time and cooperation and information sharing arrangements may therefore need to reflect that variation.

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Certified Basel iii Professional (CBiiiPro) Distance Learning and Online Certification Program

To become a Certified Basel iii Professional (CBiiiPro) you must follow the steps described at:
www.basel-iii-association.com/Basel_III_Distance_Learning_Online_Certification.html

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You may consider to become a BiiiCPA Authorized Certified Trainer, Certified Basel iii Professional Trainer (BiiiCPA-ACT / CBiiiProT).

This is an additional advantage on your resume, serving as a third-party endorsement to your knowledge and experience. Certificates are important when being considered for a promotion or other career opportunities. You give the necessary assurance that you have the knowledge and skills to accept more responsibility.

To learn more:
www.basel-iii-association.com/BiiiCPA_Authorized_Certified_Trainer.html