Core Principles

for

Effective Banking Supervision

Basle Committee on Banking Supervision

Basle
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Core Principles for Effective Banking Supervision
(Basle Core Principles)

1. Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. The need to **improve the strength of financial systems** has attracted growing international concern. The Communiqué issued at the close of the Lyon G-7 Summit in June 1996 called for action in this domain. Several official bodies, including the Basle Committee on Banking Supervision, the Bank for International Settlements, the International Monetary Fund and the World Bank, have recently been examining ways to strengthen financial stability throughout the world.

2. The Basle Committee on Banking Supervision[1] has been working in this field for many years, both directly and through its many contacts with banking supervisors in every part of the world. In the last year and a half, it has been examining how best to expand its efforts aimed at strengthening prudential supervision in all countries by building on its relationships with countries outside the G-10 as well as on its earlier work to enhance prudential supervision in its member countries. In particular, the Committee has prepared two documents for release:

- a comprehensive set of **Core Principles** for effective banking supervision (The Basle Core Principles) (attached); and,
- a **Compendium** (to be updated periodically) of the existing Basle Committee recommendations, guidelines and standards most of which are cross-referenced in the Core Principles document.

Both documents have been endorsed by the G-10 central bank Governors. They were submitted to the G-7 and G-10 Finance Ministers in preparation for the June 1997 Denver Summit in the hope that they would provide a useful mechanism for strengthening financial stability in all countries.

3. In developing the Principles, the Basle Committee has worked closely with **non-G-10 supervisory authorities**. The document has been prepared in a group containing representatives from the Basle Committee and from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Nine other countries (Argentina, Brazil, Hungary, India,

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1 The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

Indonesia, Korea, Malaysia, Poland and Singapore) were also closely associated with the work. The drafting of the Principles benefited moreover from broad consultation with a larger group of individual supervisors, both directly and through the regional supervisory groups.

4. The Basle Core Principles comprise **twenty-five basic Principles** that need to be in place for a supervisory system to be effective. The Principles relate to:

Preconditions for effective banking supervision - Principle 1
Licensing and structure - Principles 2 to 5
Prudential regulations and requirements - Principles 6 to 15
Methods of ongoing banking supervision - Principles 16 to 20
Information requirements - Principle 21
Formal powers of supervisors - Principle 22, and
Cross-border banking - Principles 23 to 25.

In addition to the Principles themselves, the document contains explanations of the various methods supervisors can use to implement them.

5. National agencies should apply the Principles in the supervision of all banking organisations within their jurisdictions.[2] The Principles are **minimum requirements** and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries.

6. The Basle Core Principles are intended to serve as a basic reference for **supervisory and other public authorities in all countries and internationally**. It will be for national supervisory authorities, many of which are actively seeking to strengthen their current supervisory regime, to use the attached document to review their existing supervisory arrangements and to initiate a programme designed to address any deficiencies as quickly as is practical within their legal authority. The Principles have been designed to be verifiable by supervisors, regional supervisory groups, and the market at large. The Basle Committee will play a role, together with other interested organisations, in monitoring the progress made by individual countries in implementing the Principles. It is suggested that the IMF, the World Bank and other interested organisations use the Principles in assisting individual countries to strengthen their supervisory arrangements in connection with work aimed at promoting overall macroeconomic and financial stability. Implementation of the Principles will be reviewed at the International Conference of Banking Supervisors in October 1998 and biennially thereafter.

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[2] In countries where non-bank financial institutions provide financial services similar to those of banks, many of the Principles set out in this document are also capable of application to such non-bank financial institutions.

7. Supervisory authorities throughout the world are encouraged to **endorse** the Basle Core Principles. The members of the Basle Committee and the sixteen other supervisory agencies that have participated in their drafting all agree with the content of the document.

8. The chairpersons of the **regional supervisory groups**[3] are supportive of the Basle Committee's efforts and are ready to promote the endorsement of the Core Principles among their membership. Discussions are in progress to define the role the regional groups can play in securing the endorsement of the Principles and in monitoring implementation by their members.

9. The Basle Committee believes that achieving consistency with the Core Principles by every country will be a significant step in the process of improving financial stability domestically and internationally. The speed with which this objective will be achieved will vary. In many countries, substantive **changes in the legislative framework** and in the powers of supervisors will be necessary because many supervisory authorities do not at present have the statutory authority to implement all of the Principles. In such cases, the Basle Committee believes it is essential that national legislators give urgent consideration to the changes necessary to ensure that the Principles can be applied in all material respects.

10. **The Basle Committee** will continue to pursue its standard-setting activities in key risk areas and in key elements of banking supervision as it has done in documents such as those reproduced in the Compendium. The Basle Core Principles will serve as a reference point for future work to be done by the Committee and, where appropriate, in cooperation with non-G-10 supervisors and their regional groups. The Committee stands ready to encourage work at the national level to implement the Principles in conjunction with other supervisory bodies and interested parties. Finally, the Committee is committed to strengthening its interaction with supervisors from non-G-10 countries and intensifying its considerable investment in technical assistance and training.

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[3] Arab Committee on Banking Supervision, Caribbean Banking Supervisors Group, Association of Banking Supervisory Authorities of Latin America and the Caribbean, Eastern and Southern Africa Banking Supervisors Group, EMEAP Study Group on Banking Supervision, Group of Banking Supervisors from Central and Eastern European Countries, Gulf Cooperation Council Banking Supervisors' Committee, Offshore Group of Banking Supervisors, Regional Supervisory Group of Central Asia and Transcaucasia, SEANZA Forum of Banking Supervisors, Committee of Banking Supervisors in West and Central Africa.

LIST OF CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

6. Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

7. An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior

management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Information Requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the

bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border Banking

23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

SECTION I: INTRODUCTION

Effective supervision of banking organisations is an essential component of a strong economic environment in that the banking system plays a central role in making payments and mobilising and distributing savings. The task of supervision is to ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business. Strong and effective banking supervision provides a public good that may not be fully provided in the marketplace and, along with effective macroeconomic policy, is critical to financial stability in any country. While the cost of banking supervision is indeed high, the cost of poor supervision has proved to be even higher.

In drawing up these core principles for effective banking supervision the following precepts are fundamental:

- the key objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors;
- supervisors should encourage and pursue market discipline by encouraging good corporate governance (through an appropriate structure and set of responsibilities for a bank's board of directors and senior management)[4] and enhancing market transparency and surveillance;
- in order to carry out its tasks effectively, a supervisor must have operational independence, the means and powers to gather information both on and off site, and the authority to enforce its decisions;
- supervisors must understand the nature of the business undertaken by banks and ensure to the extent possible that the risks incurred by banks are being adequately managed;

[4] This document refers to a management structure composed of a board of directors and senior management. The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the notions of the board of directors and the senior management are used in this document not to identify legal constructs but rather to label two decision-making functions within a bank.

- effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources allocated accordingly;
- supervisors must ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management, and effective control systems and accounting records; and
- close cooperation with other supervisors is essential, particularly where the operations of banking organisations cross national boundaries.

Banking supervision should foster an efficient and competitive banking system that is responsive to the public's need for good quality financial services at a reasonable cost. Generally, it should be recognised that there is a trade-off between the level of protection that supervision provides and the cost of financial intermediation. The lower the tolerance of risk to banks and the financial system, the more intrusive and costly supervision is likely to be, eventually having an adverse effect on innovation and resource allocation.

Supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are a part of risk-taking. The way in which failures are handled, and their costs borne, is in large part a political matter involving decisions on whether, and the extent to which, public funds should be committed to supporting the banking system. Such matters cannot therefore always be entirely the responsibility of banking supervisors; however, supervisors should have in place adequate arrangements for resolving problem bank situations.

There are certain infrastructure elements that are required to support effective supervision. Where such elements do not exist, supervisors should seek to persuade government to put them in place (and may have a role in designing and developing them). These elements are discussed in Section II.

In some countries responsibility for licensing banks is separate from the process of ongoing supervision. It is clearly essential that, wherever the responsibility lies, the licensing process establishes the same high standards as the process of ongoing supervision which is the main focus of this paper. Section III therefore discusses some principles and issues that should be addressed in the licensing process.

The core principles of banking supervision set out above and expanded in Sections III-VI of this document will provide the foundation necessary to achieve a sound supervisory system. Local characteristics will need to be taken into account in the specific way in which these standards are implemented. These standards are necessary but may not be sufficient, on their own, in all situations. Supervisory systems should take into account the nature of and risks involved in the local banking market as well as more generally the local infrastructure. Each country should therefore consider to what extent it needs to supplement these standards with additional requirements to address particular risks and general conditions prevailing in its own market. Furthermore, banking supervision is a dynamic function that needs to respond to changes in the marketplace. Consequently supervisors must be prepared to reassess periodically their supervisory policies and practices in the light of new trends or developments. A sufficiently flexible legislative framework is necessary to enable them to do this.

SECTION II: PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

Banking supervision is only part of wider arrangements that are needed to promote stability in financial markets. These arrangements include:

1. sound and sustainable macro-economic policies;
2. a well developed public infrastructure;
3. effective market discipline;
4. procedures for efficient resolution of problems in banks; and
5. mechanisms for providing an appropriate level of systemic protection (or public safety net).

1. *Providing sound and sustainable macro-economic policies* are not within the competence of banking supervisors. Supervisors, however, will need to react if they perceive that existing policies are undermining the safety and soundness of the banking system. In the absence of sound macro-economic policies, banking supervisors will be faced with a virtually impossible task. Therefore, sound macro-economic policies must be the foundation of a stable financial system.

2. *A well developed public infrastructure* needs to cover the following facilities, which, if not adequately provided, can significantly contribute to the destabilisation of financial systems:

- a system of business laws including corporate, bankruptcy, contract, consumer protection and private property laws, that is consistently enforced and provides a mechanism for fair resolution of disputes;

- comprehensive and well-defined accounting principles and rules that command wide international acceptance;

- a system of independent audits for companies of significant size so that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;

- effective banking supervision (as outlined in this document);

- well-defined rules governing, and adequate supervision of, other financial markets and, where appropriate, their participants; and,

- a secure and efficient payment and clearing system for the settlement of financial transactions where counterparty risks are controlled.

3. *Effective market discipline* depends on an adequate flow of information to market participants, appropriate financial incentives to reward well managed institutions and arrangements that ensure that investors are not insulated from the consequences of their decisions. Among the issues to be addressed are corporate governance and ensuring that accurate, meaningful, transparent and timely information is provided by borrowers to investors and creditors.

Market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives. In these circumstances, it is important that if guarantees are provided for such lending, they are disclosed and arrangements are made to compensate financial institutions when policy loans cease to perform.

4. Sufficiently flexible powers are necessary in order to effect an *efficient resolution of problems in banks*. Where problems are remediable, supervisors will normally seek to identify and implement solutions that fully address their concerns; where they are not, the prompt and orderly exit of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system. Forebearance, whether or not the result of political pressure, normally leads to worsening problems and higher resolution costs. The supervisory agency should be responsible for, or assist in, the orderly exit of problem banks in order to ensure that depositors are repaid to the fullest extent possible from the resources of the bank (supplemented by any applicable deposit insurance)[5] and ahead of shareholders, subordinated debt holders and other connected parties.

In some cases, the best interests of depositors may be served by some form of restructuring, possibly takeover by a stronger institution or injection of new capital or shareholders. Supervisors may be able to facilitate such outcomes. It is essential that the end result fully meets all supervisory requirements, that it is realistically achievable in a short and determinate time frame, and that, in the interim, depositors are protected.

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[5] As deposit insurance interacts with banking supervision, some basic principles are discussed in Appendix II.

5. Deciding on the *appropriate level of systemic protection* is by and large a policy question to be taken by the relevant authorities (including the central bank), particularly where it may result in a commitment of public funds. Supervisors will also normally have a role to play because of their in-depth knowledge of the institutions involved. In order to preserve the operational independence of supervisors, it is important to draw a clear distinction between this systemic protection (or safety net) role and day-to-day supervision of solvent institutions. In handling systemic issues, it will be necessary to address, on the one hand, risks to confidence in the financial system and contagion to otherwise sound institutions, and, on the other hand, the need to minimise the distortion to market signals and discipline. Deposit insurance arrangements, where they exist, may also be triggered.

Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banking organisations. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking organisations and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

This standard requires the following components to be in place:

- a clear, achievable and consistent framework of responsibilities and objectives set by legislation for (each of) the supervisor(s) involved, but with operational independence to pursue them free from political pressure and with accountability for achieving them;

- adequate resources (including staffing, funding and technology) to meet the objectives set, provided on terms that do not undermine the autonomy, integrity and independence of the supervisory agency;

- a framework of banking law that sets out minimum standards that banks must meet; allows supervisors sufficient flexibility to set prudential rules administratively, where necessary, to achieve the objectives set as well as to utilise qualitative judgement; provides powers to gather and independently verify information; and, gives supervisors power to enforce a range of penalties that may be applied when prudential requirements are not being met (including powers to remove individuals, invoke sanctions and revoke licences);

- protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties; and,

- a system of interagency cooperation and sharing of relevant information among the various official agencies, both domestic and foreign, responsible for the safety and soundness of the financial system; this cooperation should be supported by arrangements for protecting the confidentiality of supervisory information and ensuring that it is used only for purposes related to the effective supervision of the institutions concerned.

SECTION III: LICENSING PROCESS AND APPROVAL FOR CHANGES IN STRUCTURE

Principle 2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

Principle 3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

In order to facilitate a healthy financial system, and to define precisely the population of institutions to be supervised, the arrangements for licensing banking organisations and the scope of activities governed by licences should be clearly defined. In particular, at a minimum, the activity of taking a proper bank deposit from the public would typically be reserved for institutions that are licensed and subject to supervision as banks. The term “bank” should be clearly defined and the use of the word “bank”[6] in names should be controlled to the extent possible in those circumstances where the general public might be misled by unlicensed, unsupervised institutions implying otherwise by the use of “bank” in their titles.

By basing banking supervision on a system of licensing (or chartering) deposit-taking institutions (and, where appropriate, other types of financial institutions), the supervisors will have a means of identifying the population to be supervised and entry to the banking system will be controlled. The licensing authority should determine that new banking organisations have suitable shareholders, adequate financial strength, a legal structure in line with its operational structure, and management with sufficient expertise and integrity to operate the bank in a sound and prudent manner. It is important that the criteria for issuing licences are consistent with those applied in ongoing supervision so that they can provide one of the bases for withdrawing authorisation when an established institution no longer meets the criteria. Where the licensing and supervisory authorities are different, it is essential that they cooperate closely in the licensing process and that the supervisory authority has a legal right to have its views considered by the licensing authority. Clear and objective criteria also

6 This includes any derivations of the word "bank", including "banking".

reduce the potential for political interference in the licensing process. Although the licensing process cannot guarantee that a bank will be well run after it opens, it can be an effective method for reducing the number of unstable institutions that enter the banking system. Licensing regulations, as well as supervisory tools, should be designed to limit the number of bank failures and the amount of depositor losses without inhibiting the efficiency and competitiveness of the banking industry by blocking entry to it. Both elements are necessary to maintain public confidence in the banking system.

Having established strict criteria for reviewing a banking licence application, the licensing authority must have the right to reject applications if it cannot be satisfied that the criteria set are met. The licensing process, at a minimum, should consist of an assessment of the banking organisation’s ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital adequacy; when the proposed owner is a foreign bank, prior consent of its home country supervisor should be obtained.

A. Ownership Structure

Supervisors must be able to assess the ownership structure of banking organisations. This assessment should include the bank's direct and indirect controlling and major[7] direct or indirect shareholders. This assessment should review the controlling shareholders' past banking and non-banking business ventures and their integrity and standing in the business community, as well as the financial strength of all major shareholders and their ability to provide further financial support should it be needed. As part of the process of checking integrity and standing, the supervisor should determine the source of the initial capital to be invested.

Where a bank will be part of a larger organisation, licensing and supervisory authorities should determine that the ownership and organisational structure will not be a source of weakness and will minimise the risk to depositors of contagion from the activities conducted by other entities within the larger organisation. The other interests of the bank's major shareholders should be reviewed and the financial condition of these related entities assessed. The bank should not be used as a captive source of finance for its owners. When evaluating the corporate affiliations and structure of the proposed bank within a conglomerate, the licensing and supervisory authorities should determine that there will be sufficient transparency to permit them to identify the individuals responsible for the sound operations of the bank and to ensure that these individuals have the autonomy within the

7 In many countries, a "major" shareholder is defined as holding 10% or more of a bank's equity capital.

conglomerate structure to respond quickly to supervisory recommendations and requirements. Finally, the licensing and supervisory authorities must have the authority to prevent corporate affiliations or structures that hinder the effective supervision of banks. These can include structures where material parts are in jurisdictions where secrecy laws or inadequate financial supervision are significant obstacles and structures where the same owners control banks with parallel structures which cannot be subjected to consolidated supervision because there is no common corporate link.

B. Operating Plan, Systems of Control and Internal Organisation

Another element to review during the licensing process is the operations and strategies proposed for the bank. The operating plan should describe and analyse the market area from which the bank expects to draw the majority of its business and establish a strategy for the bank's ongoing operations. The application should also describe how the bank will be organised and controlled internally. The licensing agency should determine if these arrangements are consistent with the proposed strategy and should also determine whether adequate internal policies and procedures have been developed and adequate resources deployed. This should include determining that appropriate corporate governance will be in place (a management structure with clear accountability, a board of directors with ability to provide an independent check on management, and independent audit and compliance functions) and that the "four eyes" principle (segregation of various functions, cross-checking, dual control of assets, double signatures, etc.) will be followed. It is essential to determine that the legal and operational structures will not inhibit supervision on either a solo or consolidated basis and that the supervisor will have adequate access to management and information. For this reason, supervisors should not grant a licence to a bank when the head office will be located outside its jurisdiction unless the supervisor is assured that it will have adequate access to management and information. (See Section E below for licensing of banks incorporated abroad.)

C. Fit and Proper Test for Directors and Senior Managers

A key aspect of the licensing process is an evaluation of the competence, integrity and qualifications of proposed management, including the board of directors[8]. The licensing agency should obtain the necessary information about the proposed directors and senior managers to consider individually and collectively their banking experience, other business experience, personal integrity and relevant skill. This evaluation of management should involve background checks on whether previous activities, including regulatory or judicial judgements, raise doubts concerning their competence, sound judgement, or honesty. It is

[8] With regard to the "fit and proper" evaluation, where appropriate, differentiation can be made between the supervisory board and the executive board.

critical that the bank's proposed management team includes a substantial number of individuals with a proven track record in banking. Supervisors should have the authority to require notification of subsequent changes in directors and senior management and to prevent such appointments if they are deemed to be detrimental to the interests of depositors.

D. Financial Projections Including Capital

The licensing agency should review *pro forma* financial statements and projections for the proposed bank. The review should determine whether the bank will have sufficient capital to support its proposed strategic plan, especially in light of start-up costs and possible operational losses in the early stages. In addition, the licensing authority should assess whether the projections are consistent and realistic, and whether the proposed bank is likely to be viable. In most countries, licensing agencies have established a minimum initial capital amount. The licensing agency should also consider the ability of shareholders to supply additional support, if needed, once the bank has commenced activities. If there will be a corporate shareholder with a significant holding, an assessment of the financial condition of the corporate parent should be made, including its capital strength.

E. Prior Approval from the Home Country Supervisor When the Proposed Owner Is a Foreign Bank (See also Section VI.B.)

When a foreign bank, subsidiary of a foreign banking group, or a foreign non-banking financial institution (subject to a supervisory authority) proposes to establish a local bank or branch office, the licensing authority should consider whether the Basle Minimum Standards[9] are met and in particular the licence should not normally be approved until the consent of the home country supervisor of the bank or banking group has been obtained. The host authority should also consider whether the home country supervisor capably performs its supervisory task on a consolidated basis[10]. In assessing whether capable consolidated supervision is provided, the host licensing authority should consider not only the nature and scope of the home country supervisory regime but also whether the structure of the applicant or its group is such as to not inhibit effective supervision by the home and host country supervisory authorities.

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9 See "*Minimum Standards for the supervision of international banking groups and their cross-border establishments*" - Volume III of the Compendium.

10 See *"The Supervision of cross-border banking"* (Annex B) - Volume III of the Compendium - for guidance on assessing whether a supervisor capably performs such tasks.

F. Transfer of a Bank's Shares

Principle 4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

In addition to licensing new banks, banking supervisors should be notified of any future significant direct or indirect investment in the bank or any increases or other changes in ownership over a particular threshold and should have the power to block such investments or prevent the exercise of voting rights in respect of such investments if they do not meet criteria comparable to those used for approving new banks. Notifications are often required for ownership or voting control involving established percentages of a bank's outstanding shares.[11] The threshold for approval of significant ownership changes may be higher than that for notification.

G. Major Acquisitions or Investments by a Bank

Principle 5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

In many countries, once a bank has been licensed, it may conduct any activities normally permissible for banks or any range of activities specified in the banking licence. Consequently, certain acquisitions or investments may be automatically permissible if they comply with certain limits set by the supervisors or by banking law or regulation.

In certain circumstances, supervisors require banks to provide notice or obtain explicit permission before making certain acquisitions or investments. In these instances, supervisors need to determine if the banking organisation has both the financial and managerial resources to make the acquisition and may need to consider also whether the investment is permissible under existing banking laws and regulations. The supervisor should clearly define what types and amounts of investments need prior approval and for what cases notification is sufficient. Notification after the fact is most appropriate in those instances where the activity is closely related to banking and the investment is small relative to the bank's total capital.

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11 These established percentages typically range between 5 and 10%.

SECTION IV: ARRANGEMENTS FOR ONGOING BANKING SUPERVISION

A. Risks in Banking

Banking, by its nature, entails taking a wide array of risks. Banking supervisors need to understand these risks and be satisfied that banks are adequately measuring and managing them. The key risks faced by banks are discussed below.

Credit risk

The extension of loans is the primary activity of most banks. Lending activities require banks to make judgements related to the creditworthiness of borrowers. These judgements do not always prove to be accurate and the creditworthiness of a borrower may decline over time due to various factors. Consequently, a major risk that banks face is credit risk or the failure of a counterparty to perform according to a contractual arrangement. This risk applies not only to loans but to other on- and off-balance sheet exposures such as guarantees, acceptances and securities investments. Serious banking problems have arisen from the failure of banks to recognise impaired assets, to create reserves for writing off these assets, and to suspend recognition of interest income when appropriate.

Large exposures to a single borrower, or to a group of related borrowers are a common cause of banking problems in that they represent a credit risk concentration. Large concentrations can also arise with respect to particular industries, economic sectors, or geographical regions or by having sets of loans with other characteristics that make them vulnerable to the same economic factors (e.g., highly-leveraged transactions).

Connected lending - the extension of credit to individuals or firms connected to the bank through ownership or through the ability to exert direct or indirect control - if not properly controlled, can lead to significant problems because determinations regarding the creditworthiness of the borrower are not always made objectively. Connected parties include a bank's parent organisation, major shareholders, subsidiaries, affiliated entities, directors, and executive officers. Firms are also connected when they are controlled by the same family or group. In these, or in similar, circumstances, the connection can lead to preferential treatment in lending and thus greater risk of loan losses.

Country and transfer risk

In addition to the counterparty credit risk inherent in lending, international lending also includes country risk, which refers to risks associated with the economic, social and political environments of the borrower's home country. Country risk may be most apparent when lending to foreign governments or their agencies, since such lending is typically unsecured, but is important to consider when making any foreign loan or investment, whether to public or private borrowers. There is also a component of country risk called "transfer risk" which arises when a borrower's obligation is not denominated in the local currency. The currency of the obligation may become unavailable to the borrower regardless of its particular financial condition.

Market risk

Banks face a risk of losses in on- and off-balance sheet positions arising from movements in market prices. Established accounting principles cause these risks to be typically most visible in a bank's trading activities, whether they involve debt or equity instruments, or foreign exchange or commodity positions. One specific element of market risk is foreign exchange risk. Banks act as "market-makers" in foreign exchange by quoting rates to their customers and by taking open positions in currencies. The risks inherent in foreign exchange business, particularly in running open foreign exchange positions, are increased during periods of instability in exchange rates.

Interest rate risk

Interest rate risk refers to the exposure of a bank's financial condition to adverse movements in interest rates. This risk impacts both the earnings of a bank and the economic value of its assets, liabilities and off-balance sheet instruments. The primary forms of interest rate risk to which banks are typically exposed are: (1) repricing risk, which arises from timing differences in the maturity (for fixed rate) and repricing (for floating rate) of bank assets, liabilities and off-balance sheet positions; (2) yield curve risk, which arises from changes in the slope and shape of the yield curve; (3) basis risk, which arises from imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics; and (4) optionality, which arises from the express or implied options imbedded in many bank assets, liabilities and off-balance sheet portfolios.

Although such risk is a normal part of banking, excessive interest rate risk can pose a significant threat to a bank's earnings and capital base. Managing this risk is of growing importance in sophisticated financial markets where customers actively manage their interest rate exposure. Special attention should be paid to this risk in countries where interest rates are being deregulated.

Liquidity risk

Liquidity risk arises from the inability of a bank to accommodate decreases in liabilities or to fund increases in assets. When a bank has inadequate liquidity, it cannot obtain sufficient funds, either by increasing liabilities or by converting assets promptly, at a reasonable cost, thereby affecting profitability. In extreme cases, insufficient liquidity can lead to the insolvency of a bank.

Operational risk

The most important types of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way, for example, by its dealers, lending officers or other staff exceeding their authority or conducting business in an unethical or risky manner. Other aspects of operational risk include major failure of information technology systems or events such as major fires or other disasters.

Legal risk

Banks are subject to various forms of legal risk. This can include the risk that assets will turn out to be worth less or liabilities will turn out to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for banking business and involve costs to it and many or all other banks; and, laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering new types of transactions and when the legal right of a counterparty to enter into a transaction is not established.

Reputational risk

Reputational risk arises from operational failures, failure to comply with relevant laws and regulations, or other sources. Reputational risk is particularly damaging for banks since the nature of their business requires maintaining the confidence of depositors, creditors and the general marketplace.

B. Development and Implementation of Prudential Regulations and Requirements

The risks inherent in banking must be recognised, monitored and controlled. Supervisors play a critical role in ensuring that bank management does this. An important part of the supervisory process is the authority of supervisors to develop and utilise prudential regulations and requirements to control these risks, including those covering capital adequacy, loan loss reserves, asset concentrations, liquidity, risk management and internal controls. These may be qualitative and/or quantitative requirements. Their purpose is to limit imprudent risk-taking by banks. These requirements should not supplant management decisions but rather impose minimum prudential standards to ensure that banks conduct their activities in an appropriate manner. The dynamic nature of banking requires that supervisors periodically assess their prudential requirements and evaluate the continued relevance of existing requirements as well as the need for new requirements.

1. Capital adequacy

Principle 6: Banking supervisors must set prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

Equity capital serves several purposes: it provides a permanent source of revenue for the shareholders and funding for the bank; it is available to bear risk and absorb losses; it provides a base for further growth; and it gives the shareholders reason to ensure that the bank is managed in a safe and sound manner. Minimum capital adequacy ratios are necessary to reduce the risk of loss to depositors, creditors and other stakeholders of the bank and to help supervisors pursue the overall stability of the banking industry. Supervisors must set prudent and appropriate minimum capital adequacy requirements and encourage banks to operate with capital in excess of the minimum. Supervisors should consider requiring higher than minimum capital ratios when it appears appropriate due to the particular risk profile of the bank or if there are uncertainties regarding the asset quality, risk concentrations or other adverse characteristics of a bank's financial condition. If a bank's ratio falls below the minimum, banking supervisors should ensure that it has realistic plans to restore the minimum in a timely fashion. Supervisors should also consider whether additional restrictions are needed in such cases.

In 1988, the member countries of the Basle Committee on Banking Supervision agreed to a method of ensuring a bank's capital adequacy.[12] Many other countries have adopted the Capital Accord or something very close to it. The Accord addresses two important elements of a bank's activities: (1) different levels of credit risk inherent in its balance sheet and (2) off-balance sheet activities, which can represent a significant risk exposure.

The Accord defines what types of capital are acceptable for supervisory purposes and stresses the need for adequate levels of "core capital" (in the accord this capital is referred to as tier one capital) consisting of permanent shareholders' equity and disclosed reserves that are created or maintained by appropriations of retained earnings or other surplus (e.g. share

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12 See "*International convergence of capital measurement and capital standards*" - Volume I of the Compendium.

premiums, retained profit, general reserves and reserves required by law). Disclosed reserves also include general funds that meet the following criteria: (1) allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential tax liabilities; (2) the funds and movements into or out of them must be disclosed separately in the bank's published accounts; (3) the funds must be available to a bank to meet losses; and (4) losses cannot be charged directly to the funds but must be taken through the profit and loss account. The Accord also acknowledges other forms of supplementary capital (referred to as tier two capital), such as other forms of reserves and hybrid capital instruments that should be included within a system of capital measurement.

The Accord assigns risk weights to on- and off-balance sheet exposures according to broad categories of relative riskiness. The framework of weights has been kept as simple as possible with only five weights being used: 0, 10, 20, 50 and 100%.

The Accord sets minimum capital ratio requirements for internationally active banks of 4% tier one capital and 8% total (tier one plus tier two) capital in relation to risk-weighted assets.[13] These requirements are applied to banks on a consolidated basis.[14] It must be stressed that these ratios are considered a minimum standard and many supervisors require higher ratios or apply stricter definitions of capital or higher risk weights than set out in the Accord.

2. Credit risk management

(i) Credit-granting standards and credit monitoring process

Principle 7: An essential part of any supervisory system is the evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Supervisors need to ensure that the credit and investment function at individual banks is objective and grounded in sound principles. The maintenance of prudent written lending policies, loan approval and administration procedures, and appropriate loan documentation are essential to a bank's management of the lending function. Lending and investment activities should be based on prudent underwriting standards that are approved by the bank's board of directors and clearly communicated to the bank's lending officers and

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13 Although the Accord applies to internationally active banks, many countries also apply the Accord to their domestic banks.

14 Supervisors should, of course, also give consideration to monitoring the capital adequacy of banks on a non-consolidated basis.

staff. It is also critical for supervisors to determine the extent to which the institution makes its credit decisions free of conflicting interests and inappropriate pressure from outside parties.

Banks must also have a well-developed process for ongoing monitoring of credit relationships, including the financial condition of borrowers. A key element of any management information system should be a data base that provides essential details on the condition of the loan portfolio, including internal loan grading and classifications.

(ii) Assessment of asset quality and adequacy of loan loss provisions and reserves

Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.

Supervisors should assess a bank's policies regarding the periodic review of individual credits, asset classification and provisioning. They should be satisfied that these policies are being reviewed regularly and implemented consistently. Supervisors should also ensure that banks have a process in place for overseeing problem credits and collecting past due loans. When the level of problem credits at a bank is of concern to the supervisors, they should require the bank to strengthen its lending practices, credit-granting standards, and overall financial strength.

When guarantees or collateral are provided, the bank should have a mechanism in place for continually assessing the strength of these guarantees and appraising the worth of the collateral. Supervisors should also ensure that banks properly record and hold adequate capital against off-balance sheet exposures when they retain contingent risks.

(iii) Concentrations of risk and large exposures

Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Banking supervisors must set prudential limits to restrict bank exposures to single borrowers, groups of related borrowers and other significant risk concentrations.[15] These

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[15] As a guide to appropriate controls on concentrations of risk, the Basle Committee has adopted a best practices paper covering large credit exposures. This 1991 paper addresses the definitions of credit exposures, single borrowers, and related counterparties, and also discusses appropriate levels of large

limits are usually expressed in terms of a percentage of bank capital and, although they vary, 25% of capital is typically the most that a bank or banking group may extend to a private sector non-bank borrower or a group of closely related borrowers without specific supervisory approval. It is recognised that newly-established or very small banks may face practical limits on their ability to diversify, necessitating higher levels of capital to reflect the resultant risk.

Supervisors should monitor the bank's handling of concentrations of risk and may require that banks report to them any such exposures exceeding a specified limit (e.g., 10% of capital) or exposures to large borrowers as determined by the supervisors. In some countries, the aggregate of such large exposures is also subject to limits.

(iv) Connected lending

Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Banking supervisors must be able to prevent abuses arising from connected and related party lending. This will require ensuring that such lending is conducted only on an arm's-length basis and that the amount of credit extended is monitored. These controls are most easily implemented by requiring that the terms and conditions of such credits not be more favourable than credit extended to non-related borrowers under similar circumstances and by imposing strict limits on such lending. Supervisors should have the authority, in appropriate circumstances, to go further and establish absolute limits on categories of such loans, to deduct such lending from capital when assessing capital adequacy, or to require collateralisation of such loans. Transactions with related parties that pose special risks to the bank should be subject to the approval of the bank's board of directors, reported to the supervisors, or prohibited altogether. Supervising banking organisations on a consolidated basis can in some circumstances identify and reduce problems arising from connected lending.

Supervisors should also have the authority to make discretionary judgements about the existence of connections between the bank and other parties. This is especially

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exposure limits, and risks arising from different forms of asset concentrations. See "*Measuring and controlling large credit exposures*" - Volume I of the Compendium.

necessary in those instances where the bank and related parties have taken measures to conceal such connections.

(v) Country and transfer risk

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.[16]

3. Market risk management

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Banking supervisors must determine that banks accurately measure and adequately control market risks. Where material, it is appropriate to provide an explicit capital cushion for the price risks to which banks are exposed, particularly those arising from their trading activities. Introducing the discipline that capital requirements impose can be an important further step in strengthening the soundness and stability of financial markets. There should also be well-structured quantitative and qualitative standards for the risk management process related to market risk.[17] Banking supervisors should also ensure that bank management has set appropriate limits and implemented adequate internal controls for their foreign exchange business.[18]

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16 These issues were addressed in a 1982 Basle Committee paper "*Management of banks' international lending*" - Volume I of the Compendium.

17 In January 1996 the Basle Committee issued a paper amending the Capital Accord and implementing a new capital charge related to market risk. This capital charge comes into effect by the end of 1997. In calculating the capital charge, banks will have the option of using a standardised method or their own internal models. The G-10 supervisory authorities plan to use "backtesting" (i.e., ex-post comparisons between model results and actual performance) in conjunction with banks' internal risk measurement systems as a basis for applying capital charges. See "*Overview of the Amendment to the Capital Accord to incorporate market risks*", "*Amendment to the Capital Accord to incorporate market risks*", and "*Supervisory framework for the use of 'backtesting' in conjunction with the internal models approach to market risk capital requirements*" - Volume II of the Compendium.

18 See "*Supervision of banks' foreign exchange positions*" - Volume I of the Compendium.

4. Other risk management

Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Risk management standards[19] are a necessary element of banking supervision, and increasingly important as financial instruments and risk measurement techniques become more complex. Moreover, the effect of new technologies on financial markets both permits and requires many banks to monitor their portfolios daily and adjust risk exposures rapidly in response to market and customer needs. In this environment, management, investors, and supervisors need information about a bank's exposures that is correct, informative, and provided on a timely basis. Supervisors can contribute to this process by promoting and enforcing sound policies in banks, and requiring procedures that ensure the necessary information is available.

(i) Interest rate risk

Supervisors should monitor the way in which banks control interest rate risk including effective board and senior management oversight, adequate risk management policies and procedures, risk measurement and monitoring systems, and comprehensive controls.[20] In addition, supervisors should receive sufficient and timely information from banks in order to evaluate the level of interest rate risk. This information should take appropriate account of the range of maturities and currencies in each bank's portfolio, as well as other relevant factors such as the distinction between trading and non-trading activities.

(ii) Liquidity management

The purpose of liquidity management is to ensure that the bank is able to meet fully its contractual commitments. Crucial elements of strong liquidity management include good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, and contingency planning.[21] Supervisors should expect banks to manage their assets, liabilities and off-balance

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19 The Basle Committee has recently established a sub-group to study issues related to risk management and internal controls and to provide guidance to the banking industry.

20 The Basle Committee has recently issued a paper related to the management of interest rate risk that outlines a number of principles for use by supervisory authorities when considering interest rate risk management at individual banks. See "*Principles for the management of interest rate risk*" - Volume I of the Compendium.

21 The Basle Committee has issued a paper that sets out the main elements of a model analytical framework for measuring and managing liquidity. Although the paper focuses on the use of the

sheet contracts with a view to maintaining adequate liquidity. Banks should have a diversified funding base, both in terms of sources of funds and the maturity breakdown of the liabilities. They should also maintain an adequate level of liquid assets.

(iii) Operational risk

Supervisors should ensure that senior management puts in place effective internal control and auditing procedures; also, that they have policies for managing or mitigating operational risk (e.g., through insurance or contingency planning). Supervisors should determine that banks have adequate and well-tested business resumption plans for all major systems, with remote site facilities, to protect against such events.

5. Internal controls

Principle 14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

The purpose of internal controls is to ensure that the business of a bank is conducted in a prudent manner in accordance with policies and strategies established by the bank's board of directors; that transactions are only entered into with appropriate authority; that assets are safeguarded and liabilities controlled; that accounting and other records provide complete, accurate and timely information; and that management is able to identify, assess, manage and control the risks of the business.

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framework by large, internationally-active banks, it provides guidance that should prove useful to all banks. See "*A framework for measuring and managing liquidity*" - Volume I of the Compendium.

There are four primary areas of internal controls:

- organisational structures (definitions of duties and responsibilities, discretionary limits for loan approval, and decision-making procedures);
- accounting procedures (reconciliation of accounts, control lists, periodic trial balances, etc.);
- the "four eyes" principle (segregation of various functions, cross-checking, dual control of assets, double signatures, etc.); and
- physical control over assets and investments.

These controls must be supplemented by an effective audit function that independently evaluates the adequacy, operational effectiveness and efficiency of the control systems within an organisation. Consequently, the internal auditor must have an appropriate status within the bank and adequate reporting lines designed to safeguard his or her independence.[22] The external audit can provide a cross-check on the effectiveness of this process. Banking supervisors must be satisfied that effective policies and practices are followed and that management takes appropriate corrective action in response to internal control weaknesses identified by internal and external auditors.

Banks are subject to a wide array of banking and non-banking laws and regulations and must have in place adequate policies and procedures to ensure compliance. Otherwise, violations of established requirements can damage the reputation of the bank and expose it to penalties. In extreme cases, this damage could threaten the bank's solvency. Compliance failures also indicate that the bank is not being managed with the integrity and skill expected of a banking organisation. Larger banks in particular should have independent compliance functions and banking supervisors should determine that such functions are operating effectively.

Public confidence in banks can be undermined, and bank reputations damaged, as a result of association (even if inadvertent) with drug traders and other criminals. Consequently, while banking supervisors are not generally responsible for the criminal prosecution of money laundering offences or the ongoing anti-money laundering efforts in their countries, they have a role in ensuring that banks have procedures in place, including strict "know-your-customer" policies, to avoid association or involvement with drug traders and other criminals, as well as in the general promotion of high ethical and professional

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[22] In some countries, supervisors recommend that banks establish an "audit committee" within the board of directors. The purpose of this committee is to facilitate the effective performance of board oversight.

standards in the financial sector.[23] Specifically, supervisors should encourage the adoption of those recommendations of the Financial Action Task Force on Money Laundering (FATF) that apply to financial institutions. These relate to customer identification and record-keeping, increased diligence by financial institutions in detecting and reporting suspicious transactions, and measures to deal with countries with insufficient or no anti-money laundering measures.

The occurrence of fraud in banks, or involving them, is also of concern to banking supervisors for three reasons. On a large scale it may threaten the solvency of banks and the integrity and soundness of the financial system. Second, it may be indicative of weak internal controls that will require supervisory attention. And thirdly, there are potential reputational and confidence implications which may also spread from a particular institution to the system. For these reasons, banks should have established lines of communication, both within the management chain and within an internal security or guardian function independent of management, for reporting problems. Employees should be required to report suspicious or troubling behaviour to a superior or to internal security. Moreover, banks should be required to report suspicious activities and significant incidents of fraud to the supervisors. It is not necessarily the role of supervisors to investigate fraud in banks, and the skills required to do so are specialised, but supervisors do need to ensure that appropriate authorities have been alerted. They need to be able to consider and, if necessary, act to prevent effects on other banks and to maintain an awareness of the types of fraudulent activity that are being undertaken or attempted in order to ensure that banks have controls capable of countering them.

C. Methods of Ongoing Banking Supervision

Principle 16: An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

Principle 18: Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

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[23] See "*Prevention of criminal use of the banking system for the purpose of money-laundering*" - Volume I of the Compendium.

Principle 19: Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.

Supervision requires the collection and analysis of information. This can be done on or off-site. An effective supervisory system will use both means. In some countries, on-site work is carried out by examiners and in others by qualified external auditors. In still other countries, a mixed system of on-site examinations and collaboration between the supervisors and the external auditors exists. The extent of on-site work and the method by which it is carried out depend on a variety of factors.

Regardless of their mix of on-site and off-site activities or their use of work done by external accountants, banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations. Review of the reports of internal and external auditors can be an integral part of both on-site and off-site supervision. The various factors considered during the licensing process should be periodically assessed as part of on-going supervision. Banks should be required to submit information on a periodic basis for review by the supervisors, and supervisors should be able to discuss regularly with banks all significant issues and areas of their business. If problems develop, banks should also feel that they can confide in and consult with the supervisor, and expect that problems will be discussed constructively and treated in a confidential manner. They must also recognise their responsibility to inform supervisors of important matters in a timely manner.

1. Off-site surveillance

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis. These should include basic financial statements as well as supporting schedules that provide greater detail on exposure to different types of risk and various other financial aspects of the bank, including provisions and off-balance sheet activities. The supervisory agency should also have the ability to obtain information on affiliated non-bank entities. Banking supervisors should also make full use of publicly-available information and analysis.

These reports can be used to check adherence to prudential requirements, such as capital adequacy or single debtor limits. Off-site monitoring can often identify potential problems, particularly in the interval between on-site inspections, thereby providing early detection and prompting corrective action before problems become more serious. Such reports can also be used to identify trends not only for particular institutions, but also for the banking system as a whole. These reports can provide the basis for discussions with bank management, either at periodic intervals or when problems appear. They should also be a key component of examination planning so that maximum benefit is achieved from the limited time spent conducting an on-site review.

2. On-site examination and/or use of external auditors[24]

Supervisors must have a means of validating supervisory information either through on-site examinations or use of external auditors. On-site work, whether done by examination staff of the banking supervisory agency or commissioned by supervisors but undertaken by external auditors, should be structured to provide independent verification that adequate corporate governance exists at individual banks and that information provided by banks is reliable.

On-site examinations provide the supervisor with a means of verifying or assessing a range of matters including:

- the accuracy of reports received from the bank
- the overall operations and condition of the bank
- the adequacy of the bank's risk management systems and internal control procedures
- the quality of the loan portfolio and adequacy of loan loss provisions and reserves
- the competence of management
- the adequacy of accounting and management information systems
- issues identified in off-site or previous on-site supervisory processes
- bank adherence to laws and regulations and the terms stipulated in the banking licence.

The supervisory agency should establish clear internal guidelines related to the frequency and scope of examinations. In addition, examination policies and procedures should be developed in order to ensure that examinations are conducted in a thorough and consistent manner with clear objectives.

Depending on its use of examination staff, a supervisory agency may use external auditors to fulfil the above functions in whole or in part. In some cases, such functions may

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24 In some countries, external auditors hired by the supervisory agency to conduct work on its behalf are referred to as reporting accountants.

be part of the normal audit process (e.g. assessing the quality of the loan portfolio and the level of provisions that need to be held against it). In other areas, the supervisor should have adequate powers to require work to be commissioned specifically for supervisory purposes (e.g. on the accuracy of reports filed with supervisors or the adequacy of control systems.) However, the work of external auditors should be utilised for supervisory purposes only when there is a well-developed, professionally independent auditing profession with skills to undertake the work required. In these circumstances, the supervisory agency needs to reserve the right to veto the appointment of a particular firm of external auditors where supervisory reliance is to be placed on the firm's work. In addition, supervisors should urge banking groups to use common auditors and common accounting dates throughout the group, to the extent possible.

It is also important that the supervisors and external auditors have a clear understanding of their respective roles. Before problems are detected at a bank, the external auditors should clearly understand their responsibilities for communicating with the supervisory agency and should also be protected from personal liability for disclosures, in good faith, of such information. A mechanism should be in place to facilitate discussions between the supervisors and the external auditors.[25] In many instances, these discussions should also include the bank.

In all cases, the supervisory agency should have the legal authority and means to conduct independent checks of banks based on identified concerns.

3. Supervision on a consolidated basis

An essential element of banking supervision is the ability of the supervisors to supervise the consolidated banking organisation. This includes the ability to review both banking and non-banking activities conducted by the banking organisation, either directly or indirectly (through subsidiaries and affiliates), and activities conducted at both domestic and foreign offices. Supervisors need to take into account that non-financial activities of a bank or group may pose risks to the bank. Supervisors should decide which prudential requirements will be applied on a bank-only (solo) basis, which ones will be applied on a consolidated basis, and which ones will be applied on both bases. In all cases, the banking supervisors should be aware of the overall structure of the banking organisation or group when applying

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25 The Basle Committee has reviewed the relationship between bank supervisors and external auditors and has developed best practices for supervisors with regard to their interaction with external auditors. See "*The Relationship between bank supervisors and external auditors*" - Volume III of the Compendium.

their supervisory methods.[26] Banking supervisors should also have the ability to coordinate with other authorities responsible for supervising specific entities within the organisation's structure.

D. Information Requirements of Banking Organisations

Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

For banking supervisors to conduct effective off-site supervision of banks and to evaluate the condition of the local banking market, they must receive financial information at regular intervals and this information must be verified periodically through on-site examinations or external audits. Banking supervisors must ensure that each bank maintains adequate accounting records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business. In order that the accounts portray a true and fair view, it is essential that assets are recorded at values that are realistic and consistent, taking account of current values, where relevant, and that profit reflects what, on a net basis, is likely to be received and takes into account likely transfers to loan loss reserves. It is important that banks submit information in a format that makes comparisons among banks possible although, for certain purposes, data derived from internal management information systems may also be helpful to supervisors. At a minimum, periodic reporting should include a bank's balance sheet, contingent liabilities and income statement, with supporting details and key risk exposures.

Supervisors can be obstructed or misled when banks knowingly or recklessly provide false information of material importance to the supervisory process. If a bank provides information to the supervisor knowing that it is materially false or misleading, or it does so recklessly, supervisory and/or criminal action should be taken against both the individuals involved and the institution.

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26 The Basle Committee recommended supervision on a consolidated basis in its paper "*Consolidated supervision of banks' international activities*" - Volume I of the Compendium.

1. Accounting standards

In order to ensure that the information submitted by banks is of a comparable nature and its meaning is clear, the supervisory agency will need to provide report instructions that clearly establish the accounting standards to be used in preparing the reports. These standards should be based on accounting principles and rules that command wide international acceptance and be aimed specifically at banking institutions.

2. Scope and frequency of reporting

The supervisory agency needs to have powers to determine the scope and frequency of reporting to reflect the volatility of the business and to enable the agency to track what is happening at individual banks on both a solo and consolidated basis, as well as with the banking system as a whole. The supervisors should develop a series of informational reports for banks to prepare and submit at regular intervals. While some reports may be filed as often as monthly, others may be filed quarterly or annually. In addition, some reports may be "event generated", meaning they are filed only if a particular event occurs (e.g. investment in a new affiliate). Supervisors should be sensitive to the burden that reporting imposes. Consequently, they may determine that it is not necessary for every bank to file every report. Filing status can be based on the organisational structure of the bank, its size, and the types of activities it conducts.

3. Confirmation of the accuracy of information submitted

It is the responsibility of bank management to ensure the accuracy, completeness and timeliness of prudential, financial, and other reports submitted to the supervisors. Therefore, bank management must ensure that reports are verified and that external auditors determine that the reporting systems in place are adequate and provide reliable data. External auditors should express an opinion on the annual accounts and management report supplied to shareholders and the general public. Weaknesses in bank auditing standards in a particular country may require that banking supervisors become involved in establishing clear guidelines concerning the scope and content of the audit programme as well as the standards to be used. In extreme cases where supervisors cannot be satisfied with the quality of the annual accounts or regulatory reports, or with the work done by external auditors, they should have the ability to use supervisory measures to bring about timely corrective action, and they may need to reserve the right to approve the issue of accounts to the public.

In assessing the nature and adequacy of work done by auditors, and the degree of reliance that can be placed on this work, supervisors will need to consider the extent to which the audit programme has examined such areas as the loan portfolio, loan loss reserves, non-performing assets (including the treatment of interest on such assets), asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting. Where it is competent and independent of management, internal audits can be relied upon as a source of information and may contribute usefully to the supervisors' understanding.

4. Confidentiality of supervisory information

Although market participants should have access to correct and timely information, there are certain types of sensitive information[27] that should be held confidential by banking supervisors. In order for a relationship of mutual trust to develop, banks need to know that such sensitive information will be held confidential by the banking supervisory agency and its appropriate counterparts at other domestic and foreign supervisory agencies.

5. Disclosure

In order for market forces to work effectively, thereby fostering a stable and efficient financial system, market participants need access to correct and timely information. Disclosure, therefore, is a complement to supervision. For this reason, banks should be required to disclose to the public information regarding their activities and financial position that is comprehensive and not misleading. This information should be timely and sufficient for market participants to assess the risk inherent in any individual banking organisation.[28]

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27 The types of information considered sensitive vary from country to country; however, this typically includes information related to individual customer accounts as well as problems that the supervisor is helping the bank to resolve.

28 The Basle Committee has recently established a sub-group to study issues related to disclosure and to provide guidance to the banking industry.

SECTION V: FORMAL POWERS OF SUPERVISORS

Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

A. Corrective Measures

Despite the efforts of supervisors, situations can occur where banks fail to meet supervisory requirements or where their solvency comes into question. In order to protect depositors and creditors, and prevent more widespread contagion of such problems, supervisors must be able to conduct appropriate intervention. Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action and which enable a graduated response by supervisors depending on the nature of the problems detected. In those instances where the detected problem is relatively minor, informal action such as a simple oral or written communication to bank management may be all that is warranted. In other instances, more formal action may be necessary. These remedial measures have the greatest chance of success when they are part of a comprehensive programme of corrective action developed by the bank and with an implementation timetable; however, failure to achieve agreement with bank management should not inhibit the supervisory authority from requiring the necessary corrective action.

Supervisors should have the authority not only to restrict the current activities of the bank but also withhold approval for new activities or acquisitions. They should also have the authority to restrict or suspend dividend or other payments to shareholders, as well as to restrict asset transfers and a bank's purchase of its own shares. The supervisor should have effective means to address management problems, including the power to have controlling owners, directors, and managers replaced or their powers restricted, and, where appropriate, barring individuals from the business of banking. In extreme cases, the supervisors should have the ability to impose conservatorship over a bank that is failing to meet prudential or other requirements. It is important that all remedial actions be addressed directly to the bank's board of directors since they have overall responsibility for the institution.

Once action has been taken or remedial measures have been imposed, supervisors must be vigilant in their oversight of the problems giving rise to it by periodically checking to determine that the bank is complying with the measures. There should be a progressive escalation of action or remedial measures if the problems become worse or if bank management ignores more informal requests from supervisors to take corrective action.

B. Liquidation Procedures

In the most extreme cases, and despite ongoing attempts by the supervisors to ensure that a problem situation is resolved, a banking organisation may no longer be financially viable. In such cases, the supervisor can be involved in resolutions that require a take-over by or merger with a healthier institution. When all other measures fail, the supervisor should have the ability to close or assist in the closing of an unhealthy bank in order to protect the overall stability of the banking system.

SECTION VI: CROSS-BORDER BANKING

The Principles set out in this section are consistent with the so-called Basle Concordat and its successors.[29] The Concordat establishes understandings relating to contact and collaboration between home and host country authorities in the supervision of banks' cross-border establishments. The most recent of these documents, *"The supervision of cross-border banking"*, was developed by the Basle Committee in collaboration with the Offshore Group of Banking Supervisors and subsequently endorsed by 130 countries attending the International Conference of Banking Supervisors in June 1996. This document contains twenty-nine recommendations aimed at removing obstacles to the implementation of effective consolidated supervision.

A. Obligations of Home Country Supervisors

Principle 23: Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

Principle 24: A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

As part of practising consolidated banking supervision, banking supervisors must adequately monitor and apply appropriate prudential norms to all aspects of the business conducted by their banking organisations worldwide including at their foreign branches, joint ventures and subsidiaries. A major responsibility of the parent bank supervisor is to determine that the parent bank is providing adequate oversight not only of its overseas branches but also its joint ventures and subsidiaries. This parent bank oversight should include monitoring compliance with internal controls, receiving an adequate and regular flow of information, and periodically verifying the information received. In many instances, a bank's foreign offices may be conducting business fundamentally different from the bank's domestic operations. Consequently, supervisors should determine that the bank has the expertise needed to conduct these activities in a safe and sound manner.

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29 See *"Principles for the supervision of banks' foreign establishments"*, *"Minimum standards for the supervision of international banking groups and their cross-border establishments"*, and *"The supervision of cross-border banking"*, all contained in Volume III of the Compendium.

A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, including host country supervisory authorities. This contact should commence at the authorisation stage when the host supervisor should seek the approval from the home supervisor before issuing a licence. In many cases, bilateral arrangements exist between supervisors. These arrangements can prove helpful in defining the scope of information to be shared and the conditions under which such sharing would normally be expected. Unless satisfactory arrangements for obtaining information can be agreed, banking supervisors should prohibit their banks from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.

The parent supervisor should also determine the nature and extent of supervision conducted by the host country of the local operations of the home country's banks. Where host country supervision is inadequate, the parent supervisor may need to take special additional measures to compensate, such as through on-site examinations, or by requiring additional information from the bank's head office or its external auditors. If these options can not be developed to give sufficient comfort, bearing in mind the risks involved, then the home supervisor may have no option but to request the closure of the relevant overseas establishment.

B. Obligations of Host Country Supervisors

Principle 25: Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Foreign banks often provide depth and increase competition and are therefore important participants in local banking markets. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision. Consequently, foreign bank operations should be subject to similar prudential, inspection and reporting requirements as domestic banks (recognising, of course, obvious differences such as branches not being separately capitalised).

As the host country supervisory agency supervises only a limited part of the overall operations of the foreign bank, the supervisory agency should determine that the home country supervisor practices consolidated supervision of both the domestic and overseas operations of the bank. In order for home country supervisors to practice effectively consolidated supervision, the host country supervisor must share information about the local operations of foreign banks with them provided there is reciprocity and protection of the confidentiality of the information. In addition, home country supervisors should be given on-site access to local offices and subsidiaries for appropriate supervisory purposes. Where host country laws pose obstacles to sharing information or cooperating with home country supervisors, host authorities should work to have their laws changed in order to permit effective consolidated supervision by home countries.

APPENDIX I

Special Issues Related to Government-owned Banks

Many countries have some commercial banks that are owned, wholly or substantially, by the national government or by other public bodies.[30] In other countries, government-owned commercial banks comprise the majority of the banking system, usually for historic reasons. In principle, all banks should be subject to the same operational and supervisory standards regardless of their ownership; however, the unique nature of government-owned commercial banks should be recognised.

Government-owned commercial banks typically are backed by the full resources of the government. This provides additional support and strength for these banks. Although this government support can be advantageous, it should also be noted that the correction of problems at these banks is sometimes deferred and the government is not always in a position to recapitalise the bank when required. At the same time, this support may lead to the taking of excessive risks by bank management. In addition, market discipline may be less effective when market participants know that a particular bank has the full backing of the government and consequently has access to more extensive (and possibly cheaper) funding than would be the case for a comparable privately-owned bank.

Consequently, it is important that supervisors seek to ensure that government-owned commercial banks operate to the same high level of professional skill and disciplines as required of privately-owned commercial banks in order to preserve a strong credit and control culture in the banking system as a whole. In addition, supervisors should apply their supervisory methods in the same manner to government-owned commercial banks as they do to all other commercial banks.

[30] This can include savings banks and cooperative banks. These banks are different, however, from "policy" banks that typically specialise in certain types of lending or target certain sectors of the economy.

APPENDIX II

Deposit Protection

Despite the efforts of supervisors, bank failures can occur. At such times, the possible loss of all or part of their funds increases the risk that depositors will lose confidence in other banks. Consequently, many countries have established deposit insurance plans to protect small depositors. These plans are normally organised by the government or central bank, or by the relevant bankers' association and are compulsory rather than voluntary. Deposit insurance provides a safety net for many bank creditors thereby increasing public confidence in banks and making the financial system more stable. A safety net may also limit the effect that problems at one bank might have on other, healthier, banks in the same market, thereby reducing the possibility of contagion or a chain reaction within the banking system as a whole. A key benefit of deposit insurance is that, in conjunction with logical exit procedures, it gives the banking supervisors greater freedom to let problem banks fail.

Deposit insurance can however increase the risk of imprudent behaviour by individual banks. Small depositors will be less inclined to withdraw funds even if the bank pursues high-risk strategies, thus weakening an important check on imprudent management. Government officials and supervisors need to recognise this effect of a safety net and take steps to prevent excessive risk-taking by banks. One method of limiting risk-taking is to utilise a deposit insurance system consisting of "co-insurance." Under such a system, the deposit insurance covers a percentage (e.g. 90%) of individual deposits and/or provides cover only up to a certain absolute amount so that depositors still have some funds at risk. Other methods include charging risk-based premiums or withholding deposit insurance from large, institutional depositors.

The actual form of such a programme should be tailored to the circumstances in, as well as historical and cultural features of, each country.[31]

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[31] Some form of banking deposit insurance exists in all of the member countries of the Basle Committee. The experiences of these countries should prove useful in designing a deposit insurance programme. See "*Deposit protection schemes in the G-10 countries*" - See Volume III of the Compendium.