III. Preconditions for effective banking supervision

46. An effective system of banking supervision needs to be able to effectively develop, implement, monitor and enforce supervisory policies under normal and stressed economic and financial conditions. Supervisors need to be able to respond to external conditions that can negatively affect banks or the banking system. There are a number of elements or preconditions that have a direct impact on the effectiveness of supervision in practice. These preconditions are mostly outside the direct or sole jurisdiction of banking supervisors. Where supervisors have concerns that the preconditions could impact the efficiency or effectiveness of regulation and supervision of banks, supervisors should make the government and relevant authorities aware of them and their actual or potential negative repercussions for supervisory objectives. Supervisors should work with the government and relevant authorities to address concerns that are outside the direct or sole jurisdiction of the supervisors. Supervisors should also, as part of their normal business, adopt measures to address the effects of such concerns on the efficiency or effectiveness of regulation and supervision of banks.

47. The preconditions include:

- sound and sustainable macroeconomic policies;
- a well established framework for financial stability policy formulation;
- a well developed public infrastructure;
- a clear framework for crisis management, recovery and resolution;
- an appropriate level of systemic protection (or public safety net); and
- effective market discipline.

Sound and sustainable macroeconomic policies

48. Sound macroeconomic policies (mainly fiscal and monetary policies) are the foundation of a stable financial system. Without sound policies, imbalances such as high government borrowing and spending, and an excessive shortage or supply of liquidity, may arise and affect the stability of the financial system. Further, certain government policies[13] may specifically use banks and other financial intermediaries as instruments, which may inhibit effective supervision.

Well established framework for financial stability policy formulation

49. In view of the impact and interplay between the real economy and banks and the financial system, it is important that there exists a clear framework for macroprudential surveillance and financial stability policy formulation. Such a framework should set out the authorities or those responsible for identifying systemic and emerging risks in the financial system, monitoring and analysing market and other financial and economic factors that may lead to accumulation of systemic risks, formulating and implementing appropriate policies, and

Deleted: new

assessing how such policies may affect the banks and the financial system.[1] It should also include mechanisms for effective cooperation and coordination among the relevant agencies.

Comment [W1]: RATIONALE: Given the increasing numbers of supervisors who are called upon by their mandate to consider financial inclusion alongside financial stability, an acknowledgement of this reality is appropriate.

Well developed public infrastructure

50. A well developed public infrastructure needs to comprise the following elements, which, if not adequately provided, can contribute to the weakening of financial systems and markets, or frustrate their improvement:

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

- an efficient and independent judiciary;

- comprehensive and well defined accounting principles and rules that are widely accepted internationally;

- a system of independent external audits, to ensure 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;

- availability of competent, independent and experienced professionals (eg accountants, auditors and lawyers), whose work complies with transparent technical and ethical standards set and enforced by official or professional bodies consistent with international standards, and who are subject to appropriate oversight;

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

- secure, efficient and well regulated payment and clearing systems (including central counterparties) for the settlement of financial transactions where counterparty risks are effectively controlled and managed;

- efficient and effective credit bureaus that make available credit information on borrowers; and

- public availability of basic economic, financial and social statistics.

Clear framework for crisis management, recovery and resolution

51. Effective crisis management frameworks and resolution regimes help to minimise

[1] Supervisors around the world are increasingly being called upon to address the challenge of supporting financial inclusion while also understanding potential benefits and risks it may bring. This requires attention to safety and openness to innovation, while working to achieve the core goals of effective supervision and financial stability.

potential disruptions to financial stability arising from banks and financial institutions that are in distress or failing. A sound institutional framework for crisis management and resolution requires a clear mandate and an effective legal underpinning for each relevant authority (such as banking supervisors, national resolution authorities, finance ministries and central banks). The relevant authorities should have a broad range of powers and appropriate tools provided in law to resolve a financial institution that is no longer viable and where there is no reasonable prospect of it becoming viable. There should also be agreement among the relevant authorities on their individual and joint responsibilities for crisis management and resolution, and how they will discharge these responsibilities in a coordinated manner. This should include the ability to share confidential information among one another to facilitate planning in advance to handle recovery and resolution situations and to manage such events when they occur.

Appropriate level of systemic protection (or public safety net)

52. Deciding on the appropriate level of systemic protection is a policy question to be addressed by the relevant authorities, including the government and central bank, particularly where it may result in a commitment of public funds. Supervisors will have an important role to play because of their in-depth knowledge of the financial institutions involved. In handling systemic issues, it is necessary to balance several factors: addressing the risks to confidence in the financial system and contagion to otherwise sound institutions and, minimising the distortion to market signals and discipline. A key element of the framework for systemic protection is a system of deposit insurance. Provided such a system is transparent and carefully designed, it can contribute to public confidence in the system and thus limit contagion from banks in distress.

Effective market discipline

53. Effective market discipline depends, in part, on adequate flows 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 governments or their related entities provide or guarantee the lending, such arrangements are disclosed and there is a formal process for compensating financial institutions when such loans cease to perform.

(Paragraph 16 with footnote 6)

16. The first Core Principle sets out the promotion of safety and soundness of banks and the banking system as the primary objective for banking supervision. Jurisdictions may assign other responsibilities to the banking supervisor provided they do not conflict with this primary objective[2]. It should not be an objective of banking supervision to prevent bank failures.

Comment [W2]: RATIONALE: The footnote merely acknowledges the fact that supervisors are sometimes tasked with policy mandates that extend beyond safety and soundness. The text already observes that such additional responsibilities must not conflict with the primary objective of supervision, so the text proposed for deletion is redundant (and carries an unfounded implication that financial inclusion necessarily carries with it the prospect of "deleterious effects on safety and soundness").

[2] The banking supervisor might, for instance, in some jurisdictions be tasked with responsibilities

However, supervision should aim to reduce the probability and impact of a bank failure, including by working with resolution authorities, so that when failure occurs, it is in an orderly manner.

for: (i) depositor protection, which is closely related to safety and soundness and the establishment and operation of effective deposit insurance schemes; (ii) financial stability, which will also tend to be highly dependent on the health of the banking sector; (iii) consumer protection, an area where damages, claims and reputational risk can adversely affect safety and soundness; or (iv) financial inclusion.

Deleted: where care needs to be taken to avoid deleterious effects on safety and soundness