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Mr. Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4051 Basel Switzerland

Re: Consultative Document on Core Principles for Effective Banking Supervision

Dear Mr. Byres:

The Institute of International Finance (IIF) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS) Consultative Document on *Core Principles for Effective Banking Supervision*. As reiterated in several opportunities to the BCBS, the Institute strongly supports strengthened supervisory practices and risk management. In particular, the IIF commented in its 2011 Report *Achieving Effective Supervision: An Industry Perspective,*[1] that:

"*Improved supervision has a central role in reinforcing and sustaining the sound practices being developed and consolidated in financial firms and in buttressing strengthened regulation and resolution arrangements. Global supervisory reform and improvement should therefore have a place at the center of the G-20 agenda for the coming years. […] Supervision needs to be more intensive and challenging than in the past.*"

Well-run firms have every reason to welcome strong and effective supervision.

The IIF is fully supportive of the BCBS' effort in revising the Core Principles, in particular to reflect lessons learned from the financial crisis and to align them with recent developments in regulatory and industry practices. The Institute also welcomes the additional attention to governance issues, including the new Core Principle 14 on corporate governance and the robust risk management expectations in Core Principle 15.

Below, the IIF is pleased to present some general comments regarding the proposed changes to the Core Principles. Specific comments on various sections are contained in the *Annex* to this letter.

[1] *Achieving Effective Supervision: An Industry Perspective (2011 IIF Paper)*

General comments

Additional assessment criteria

The IIF supports the increased clarity resulting from the reorganization of the 2006 Core Principles into two sections, the first covering supervisory powers, responsibilities and functions, and the second detailing the supervisory expectations of banks. The Institute is in favor of additional assessment criteria to encourage adoption of the highest standards in some jurisdictions. In fact, the Institute believes that, in some areas, the Core Principles could be more ambitious for the most advanced jurisdictions.

To this end, the IIF has suggested some additional criteria to be used for jurisdictions with more developed financial, regulatory and supervisory systems. However, the Institute would like to point out that the additional criteria should not be based on the presence of SIFIs in the jurisdiction. The IIF believes that "SIFI jurisdiction" is an unclear and unhelpful category, too dependent on the SIFI designation criteria. In the IIF view, reference to advanced or developed financial systems is more appropriate.

The IIF strongly believes that the revision of the Core Principles is an opportunity to make them more ambitious and to strengthen supervision, especially in advanced jurisdictions. The Institute would urge the BCBS to consider including the additional criteria detailed in the *Annex* to this letter, as this chance to improve supervisory practices should not be missed.

Adequacy of supervisory resources

The supervisory effectiveness work of the FSB and the IIF has emphasized the importance of adequacy of resources to high-quality, effective supervision (appropriate range of skills and experience are at least as important as sheer numbers). The Institute underscored the importance for authorities to have adequate supervisory resources in place and has suggested the need to explore possibilities such as secondments with the industry.[2] This is even more important as supervisors make judgments about business models and deal with newer areas in the Core Principles and BCBS / FSB guidance, such as understanding and assessing the effectiveness of Boards and assessing resolution plans. The IIF is concerned that such adequacy of resources does not get adequate emphasis in the revised Core Principles.

Macroprudential supervision

The IIF also supports the increased focus on macroprudential supervision and would like to emphasize that this is a new and evolving area. As acknowledged in the IIF 2011 Paper, there have been material weaknesses in supervision during the recent financial crisis. For this reason, it is important not to lose sight of the need for focusing on, and continually improving, microprudential supervision. Higher quality microprudential supervision remains central to effective supervision.

In the revised draft Core Principles macroprudential aspects have been added to several principles. In regard to some issues, such as the need for the supervisor to take

[2] *2011 IIF Paper*

account of system-wide risks, the approach seems reasonable. In others, however, the IIF believes that there is a risk that the supervisor may not be well placed to play this role, and/or the tools available to the microprudential supervisor may not be the best

It is important to ensure that any confusion between macro and microprudential supervision does not detract from good microprudential supervision. It is also important to be clear about how the Core Principles are understood and assessed. The Institute is conscious that the precise arrangements for macroprudential matters will vary across jurisdictions. It is important that this framework be well articulated and understood in each country, and that these institutional arrangements and cooperation work well in practice.

While the IIF appreciates that it is not the role of the Core Principles to cover macroprudential supervision in all its aspects, the Institute believes that there would be a benefit in going further, at least for important financial centers, and that these issues deserve separate emphasis. To help clarify what is meant by the new macroprudential supervisory process, and to avoid possible confusion, the Institute would recommend the development of a separate principle on macroprudential supervision.

In addition, the Core Principles are intended to be universally applicable. While all jurisdictions may wish to consider macroprudential issues to some degree, the reality is that they are in practice of greater focus in a more limited number of countries. That suggests that if the BCBS does not wish to consider a separate principle, the macroprudential elements be incorporated into additional criteria, which would be expected to be assessed in the most advanced jurisdictions.

Intervention

The IIF believes that timely corrective action is crucial to good supervision and would welcome guidance from the BCBS on the terms "*early*" intervention (Core Principles 8 and 11). The draft Core Principles call for supervisors to have a framework for this but give no sense of what the desirable characteristics of such a framework would be. Such guidance, which does not need to be prescriptive, would be helpful in understanding the expectations and objectives in this area. The concern is that "*early"* intervention is somewhat unclear and might suggest the type of aggressive action similar to that taken in cases of the recovery and resolution of banks. In addition, it is not as clear as it could be that often this intervention will involve banks strengthening their risk management practices relative to the inherent risk in specific aspects of their business, rather than additional capital or provisions.

The IIF has previously suggested the use of "*graduated action*"[3], and suggest that this term be included, particularly in Core Principles 8 and 11, together with elaboration in essential criteria of what countries and assessors should consider appropriate. The Institute has elaborated on this topic in the attached *Annex*.

Home-host relationships

Core Principle 13 addresses home-host supervision, which if done effectively the IIF believes is an extremely important element of good supervision. The ability to rely on supervisors in other jurisdictions is an essential element of the supervision of cross-border

[3] *2011 IIF Paper*

financial groups and at the core of the effective functioning of the global financial system. To emphasize the importance of home-host relationships, the Institute suggests that this Core Principle be broken into three separate principles, which the IIF believes are the main building blocks of effective home-host relationships:

i. information sharing,
ii. supervisory colleges, and
iii. crisis management.

If Core Principle 13 is not rewritten as three separate principles, the IIF would recommend that the existing principle be divided into three parts with a particular emphasis on strong, functioning and effective supervisory colleges. This is in line with previous IIF comments and is elaborated in the *Annex* to this letter.

Point of interpretation

The IIF notes that the word "*determines*" has replaced references to the supervisor being "*satisfied*" or that the supervisor "*ensures*" in many instances throughout the Core Principles document. It is our understanding the use of "*determines*" is intended to encourage more proactive supervision. While the Institute fully supports such a notion, it would be very helpful to have clarification that this wording would not in any case prevent supervisors from continuing to rely on, for example, banks' control, risk management and governance systems, or the external auditors—of course with appropriate testing and verification by supervisors.

This principle of "*reliance*" is a crucial element of risk-based supervision. To clarify that the use of "*determines*" allows supervisors to rely on banks' internal systems or external auditors, the IIF recommends that an elaboration of the BCBS reason for making the change be included in the C*riteria for assessing compliance with the Core Principles*.

Risk appetite

The IIF supports the requirement for a comprehensive risk management process and believes that more clarity on the definition of risk appetite would be welcome in the Core Principles.

In the 2009 IIF *Steering Committee on Implementation (SCI) Report*[4], risk appetite was defined as "*the amount and type of risk that a company is able and willing to accept in pursuit of its business objectives*". The 2011 IIF Report, *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*[5] elaborated on risk appetite statements, suggesting that they "*encompass a suitably wide range of measures and actionable elements*". An additional recommendation was that risk appetite statements include both qualitative and quantitative elements.

[4] *Reform in the Financial Services Industry: The Report of the IIF Steering Committee on Implementation (SCI) (2009 IIF SCI Report)*

[5] *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions* (*2011 IIF Risk Appetite Report)*

Without any clear guidance on risk appetite, the Institute believes that there is considerable potential for inconsistencies across jurisdictions, and therefore suggests that wording along the lines indicated above would be helpful.

Role of banks in the assessment process

The IIF would like to take this opportunity to emphasize the importance of the Core Principles for the financial industry. Assessments against the Core Principles are extremely valuable for both supervisors and banks. The Institute believes that banks could be given a more organized and formal role in the assessment process than currently, and that this should be reflected in the methodology document to be approved by the BCBS with specific indications of areas that banks are expected to be asked to comment on. For example, the industry could be asked specific questions on topics including:

i. macroprudential supervision,
ii. home-host issues including ring fencing,
iii. experience with supervisory colleges, and
iv. nature of interactions with supervisors on corporate and risk governance.

This would be in keeping with the reorganization of the Core Principles into a more logical structure and the focus on the supervisory expectations of banks in Core Principles 14 to 29.

Use of Core Principles assessments

Finally, the IIF believes that more regular assessments, and the enhanced FSB and BCBS peer review process more generally, are important. Their goal should be to promote more consistent application of the new rules and they should ensure that the importance of sound effective implementation of supervision, and of the new rules, receives adequate attention. To that end the IIF believes that more should be done, by the IMF and World Bank who conduct assessments as well as by the BCBS and FSB to use assessments and peer reviews, to promote enhanced practice.

For example, all G-20 countries should commit to publishing the results of Core Principles detailed assessments in a timely fashion. The IMF/World Bank should be asked to annually produce a summary of issues found in the assessments conducted during the year, which should be considered by the Board and forwarded to the FSB and BCBS for its consideration. This has been done occasionally but the rigor of doing this regularly would add to the usefulness and credibility of the process.

The FSB and BCBS should consider doing the same for their peer reviews of capital rules and practices more generally. These summaries should be the subject of regular discussion with representatives of the industry. The FSB should also ensure that it has an effective follow-up on countries' remedial action plans. While there may be additional actions to enhance the usefulness of assessments, the IIF believes these go a long way in the right direction.

Specific recommendations

As mentioned at the beginning of this letter, detailed comments and specific recommendations are included in the attached *Annex*.

The IIF appreciates the opportunity to provide these comments and remains at your disposal for any amplification or elaboration that you might consider helpful. The Institute looks forward to the opportunity to work with the BCBS to further strengthen banking supervision.

Sincerely,

Annex 1: Detailed Comments on "Core Principles for Effective Banking Supervision":

Principle 1: Responsibilities, objectives and powers

In the 2011 IIF Paper, the Institute argued that::

"*it is essential that supervisors have clear mandates and powers and that there is clarity about how these will be used. Supervisors should be transparent regarding the principles, objectives, and practice of supervision and on their priorities in deciding where to act.*"[6]

As a result, the Institute is broadly supportive of the direction of the changes that have been made. Nevertheless, the IIF believes that the criteria as drafted do not yet represent the kind of step forward to greater international convergence and clarity on how supervisors will use and interpret mandates, and nor do they seem to represent the kind of expansion called for in the FSB report on the *Intensity and Effectiveness of SIFI Supervision*[7] (2010 FSB Report). In particular, the criteria do not provide any guidance or detail on the mandate of a supervisor.

With this in mind, the Institute would propose that in adopting final principles, the BCBS goes much further and provides much more detail, at the very least in the form of additional criteria for supervisors in important financial centers.

The BCBS could consider the following possible additional criteria:

1. *Public disclosure of objectives and responsibilities includes disclosure of a clear and specific mandate pursuant to the overall legislative mandate. The mandate sets out in more detail the supervisor's objectives and responsibilities, its supervisory tools and techniques, and how it uses these tools and techniques to deliver its objectives. This disclosure addresses in particular*

    a) *the supervisor's policy and processes for the analysis, and efficient and effective use, of*

        - *mandatory regulatory reporting,*
        - *financial statements and accounts,*
        - *ad hoc data requests (national/international),*
        - *stress tests (national/international),*
        - *horizontal reviews (national/international),*
        - *business models and strategies, and*

[6] *2011 IIF Paper*

[7] *FSB report on Intensity and Effectiveness of SIFI Supervision (2010 FSB Report)*

- *product related risks,*

b) its framework for proactive graduated action specifying in particular conditions for supervisory intervention in the absence of tangible risk indicators,

c) its policy and processes regarding ongoing regulatory communication and interaction with individual banks,

d) guiding principles for how, assisted by its ongoing microprudential and macroprudential analysis, it challenges banks throughout the economic cycle including in particular during times of favorable economic conditions, and

e) regarding internationally operating banks, its policy and processes for close coordination and cooperation, including as appropriate joint work with relevant foreign home and host supervisors across all supervisory tools and techniques and all relevant supervisory policies and processes.

The mandate is subject to annual review and timely revision as appropriate.

2. *Where more than one authority is responsible for supervising the banking system, a binding and publicly disclosed arrangement is in place to ensure close regulatory and supervisory cooperation without any gaps or overlaps and minimizing overlap in supervisory processes where such processes involve or cut across more than one authority.*

3. *Where supervisory authorities are assigned broader responsibilities than to promote the safety and soundness of banks and the banking system any conflict with such broader objectives is effectively mitigated by clear separation of accountability and resources from potentially conflicting objectives. This separation is underpinned by a system of checks and balances for the decision making process at the top of the supervisory authority.*

Principle 2: Independence, accountability, resourcing and legal protection for supervisors

The IIF welcomes the changes on avoidance of government or industry interference, on the process and standards for the appointment and dismissal of the heads of the supervisory authority and the avoidance of conflicts of interest, all of which are sensible.

Nevertheless there is a need for adequate monitoring of implementation. The IIF would therefore urge that an effective monitoring process be put in place, that is able to ensure that weaknesses or non-compliance are addressed.

As argued in the 2011 IIF Paper, supervisors need to have adequate resources both for domestic supervision and as important, for international cooperation especially in supervisory colleges. The Institute therefore very much welcomes the change to Criterion 6 and new Criterion 7.

However, while the changes go in the right direction, the IIF would encourage the Committee to go further. Indeed as drafted, they do not yet fully capture some of the recommendations in the 2010 FSB Report, including the one suggesting that:

"*Consideration should be given to expanding on BCP 1(2), specifically to consider providing more guidance on the key features and structures that should support operational independence and also expanding on some of the criteria for assessment […] In addition, the criteria (or guidance) for appropriate budgets could be fleshed out more to highlight and promote those funding models that preserve budgetary autonomy and provide the management of supervisory agencies with the ability to establish their own budgets and line elements […] This should also be supplemented with guidance (and associated criteria) on the desirable features of accompanying accountability structures that are needed to backstop operational independence and budgetary autonomy*."

In particular, the Institute would urge that the text be made much more detailed on the need for accountability and communication. Criterion 3 stating that "*The supervisor publishes its objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives"* could usefully be supplemented by text along the following lines:

"*The supervisor publishes its objectives and is accountable through a transparent framework for the discharge of its duties in relation to those objectives. To this end the supervisor publishes an annual report with its annual strategic and operational plan setting out its annual objectives and the supervisory tools, techniques, and resources it intends to employ to deliver these objectives and an assessment of its performance against the preceding annual plan*."

As with Principle 1, the Institute would encourage the Committee to consider developing additional criteria for important financial centers. Such additional criteria could include some of the following concepts (which were discussed in the 2011 IIF Report):

1. *The supervisor relies on stable funding by the central bank and/or by industry fees and has budgetary autonomy complemented by appropriate accountability. Resources are adequate in skills and experience, particularly taking into account emerging supervisory challenges and priorities including more model-based determination of capital, desirability of more detailed assessment of inherent risks in banks' strategies, need to deal more extensively with boards of directors and assess governance effectiveness, and assess recovery and resolution plans.*

2. *The supervisor establishes its own annual budget and publishes the budget in an annual report together with its annual strategic and operational plan setting out its annual objectives and the supervisory tools, techniques, and resources it intends to employ to deliver these objectives. The strategic and operational planning including the related resource allocation takes into account the supervisor's forward-looking microprudential and macroprudential risk analysis. The plan addresses in particular the projected*

a) *off-site/on-site work including number and thematic focus of on-site examinations,*

b) *use of resident examiners,*

c) *horizontal reviews, including participation in joint/coordinated international reviews,*

d) *use of system-wide and firm-specific stress tests,*

e) *data requests beyond mandatory reporting including internationally joint/coordinated data requests,*

f) international cooperation with home and host supervisors including the number of college meetings and related joint/coordinated supervisory work,

g) countercyclical or other macroprudential measures.

3. The supervisory has flexibility in compensation for staff so that it can attract and retain necessary expertise.

The supervisor publishes an annual report on its performance against its strategic and operational plan and the objectives as set out in that plan.

4. As part of its annual planning process the supervisor establishes a rolling, at least annual, resource plan that takes stock of existing resources (number of staff and available skills), identifies resource requirements over the short- to medium-term and reviews and implements measures to bridge any quantitative or qualitative gaps. The plan addresses in particular:

a) the adequacy of its pay level and structure with a view to its ability to pay adequate compensation to attract necessary expertise,

b) the use made of flexible hiring schemes,

c) existing and projected schemes for secondment of staff to industry or other supervisory authorities including in particular key host or home jurisdictions and international supervisory authorities.

The resource planning exercise includes a regular benchmarking against comparable foreign supervisors. Periodically the supervisor performs a review of the adequacy of its resources, sends the results to the responsible authority and engages in appropriate consultation.

Principle 3: Cooperation and collaboration

Once again, the IIF supports the direction of the changes here, but would encourage going still further with regard to all jurisdictions.

Nevertheless, as noted more extensively in our discussion of Principle 10 on supervisory reporting below, the Institute encourages adoption of a much more proportionate approach to data collection. As argued in our 2011 Paper:

"The more that supervisors can minimize overlaps of supervision and avoid conflicting requests or instructions both in normal times and in stressed circumstances, the stronger their effective oversight. Critical to this will be increased reliance on supervisory colleges and much improved exchange and circulation of information."

The IIF would therefore suggest that inserting wording either under this principle or under Principle 10 on the need for supervisors to cooperate and coordinate in both the format and content of data requests.

The Institute also believes that in both Criteria 1 and 2, the words "*and informal*" should be dropped. As the crisis has shown, it is essential that formal arrangements, such as MOUs, be in place.

As a further minor point, there is inconsistency in the wording on "*financial system*" and "*banking system*" in the principles and criteria. The IIF suggests that the phrase "*and/or the stability of the financial system"* in Criterion 1 be replaced with *"and/or the banking system and/or wider financial system"*.

Principle 4: Permissible activities

The IIF supports the direction of the changes made to this principle. However, in Criterion 4, the word "*generally*" has been dropped from "*The taking of deposits from the public is generally reserved for institutions that are licensed and subject to supervision as banks*" and that the footnote has been amended to read:

"*The Committee recognises the presence in some countries of non-banking financial institutions that take deposits but may be regulated differently from banks. These institutions should be subject to a form of regulation commensurate to the type and size of their business* ***and, collectively, should not hold a significant proportion of deposits in the financial system***." (Our emphasis.)

These changes appear to refer to the issue of "shadow banking" on which the FSB and others are currently developing thinking on the most effective means of risk mitigation and, where appropriate, regulation. The IIF is developing a paper on this issue, which is expected to be released in the coming weeks. Given both the sensitivity and complexity of this issue, the Institute would strongly advise deferring any changes to this criterion until the outcome of the FSB's work is clear, and then ensuring that any changes are consistent with the approach adopted in that work.

Principle 5: Licensing criteria

The IIF broadly supports the changes made to this principle. However, there are two sentences which are unclear and where further clarification and definition would be useful.

In Criterion 1, it is not clear how the additional sentence at the end: "*The supervisor imposes prudential conditions or limitations on the newly licensed bank, where appropriate*" will be interpreted and what kind of prudential conditions are intended. Nor is it clear how "*where appropriate*" would be interpreted.

In Criterion 4, an additional sentence has been added: "*The licensing authority also determines, where appropriate, that these structures will not hinder effective implementation of corrective measures in the future.*" It is unclear how this would be applied and how "*where appropriate*" would be interpreted. Once again, the Institute would welcome greater clarity. If this is about the issue of the implications of corporate structures for resolution we would encourage that this be clarified.

Principle 6: Transfer of significant ownership

As with our comments on Principle 5, the IIF believes that the phrase "*and impose prudential conditions*" should be clarified.

Principle 7: Major acquisitions

In the 2011 *SIE Progress Report on Implementing the Recommendations for Enhanced Supervision*[8] (2011 FSB Report), supervisors identified major acquisitions as an area where further work needed to be done. In our response to that Report, the IIF supported the attention and broad approach taken towards major acquisitions. Given that the changes proposed are consistent with this, we therefore welcome the changes here.

Principle 8: Supervisory approach

Again, the IIF supports the direction of the changes to this principle, and notably the need to be forward-looking, the need to look at the wider operation of the group and the inclusion of wording on resolution. Nevertheless, as with the other principles, the Institute thinks that they could go further.

In particular, while Criteria 4, 5 and 8 hint at macroprudential oversight, they do not spell this out or go into any significant detail on either the conduct of macroprudential oversight, or supervision, or on the duty of the banking supervisor towards macroprudential authorities.

While the Institute appreciates that it is not the role of these principles to cover macroprudential oversight in all its aspects, we believe that there would be benefit in going further, at least for important financial centers.

The IIF therefore suggest that adoption of the following as additional criteria are considered:

1. *An appropriate and clear macroprudential framework for the effective and efficient monitoring, analysis and mitigation of system-wide risks is in place. Macroprudential concerns are fully incorporated in regulation and supervision. The mandate and responsibilities for the various macroprudential and microprudential entities are clearly expressed and publically disclosed, as is the means of communication/coordination between them. The supervisor or a separate authority(s) (hereinafter: the macroprudential authority) is vested with macroprudential responsibilities and equipped with the full range of necessary resources and powers to ensure implementation of a sufficiently flexible approach that takes into account the structure of financial markets and regulatory frameworks, the market dynamics including innovations in the banking and wider financial system and regulatory arbitrage as it responds to the evolving regulatory system. The authority's powers include in particular:*

[8] *SIE Progress Report on Implementing the Recommendations for Enhanced Supervision (2011 FSB Report)*

a) *The power to access, or require provision of, information that, on reasonable grounds, it judges necessary for the identification and preliminary assessment of risks to financial stability whether originating within or outside of the core regulated sectors;*

b) *If a preliminary assessment suggests that a given activity is a potential source of system-wide risk and as long as that assessment can be upheld, the power to require the provision of information related to the given activity from entities involved in that activity of a nature, volume, and frequency proportionate to the need for effective and efficient monitoring and mitigation of the identified system-wide risk on a continuous basis;*

c) *If warranted for effective and efficient monitoring and mitigation of system-wide risks, the power to recommend changes in the regulatory perimeter,*

d) *The power to issue recommendations to authorities responsible for microprudential regulation and/or supervision where it is not itself such an authority.*

2. *Formal arrangements are in place for strong and continuous communication and coordination between the macroprudential and the microprudential authority(s) or, where responsibilities are assigned to the same supervisor, between its microprudential and macroprudential functions. There is evidence that these arrangements work in practice.*

3. *Formal arrangements are in place between the macroprudential authority and other relevant foreign macroprudential authorities for cooperation, including information sharing, coordinated or joint monitoring, and analysis of risks and other joint work. There is evidence that these arrangements work in practice.*

The Institute also suggests that there be a separate pre-condition for macroprudential supervision included in the Core Principles.

As a further comment, Criterion 8 appears to be addressing the use of off-balance sheet activities to circumvent prudential requirements and the structuring of activities to avoid regulation or taxation, with the result that risk is hidden and that banks become far harder to resolve. While the IIF agrees with such objective, we believe that the wording should be further clarified. From the current text, it is unclear how the supervisor would define "*bank-like activities*", what do the words "*takes appropriate steps to draw the matter to the attention of the responsible authority"* mean, and what are the appropriate steps that a supervisor would need to take if it suspected that a bank was restructuring its activities to avoid the regulatory perimeter. The Institute would therefore suggest that this be carefully reviewed and as with Principle 4, to defer final adoption pending the outcome of the FSB's work on shadow banking.

Furthermore the IIF is concerned with the usage of the words "*early intervention*" in the draft Core Principles without definition in the essential criteria. The term is confusing and may mean different things to different supervisors. In the 2011 IIF Paper, the Institute used the term "*graduated action*" to convey supervisory action as a sliding scale and would therefore suggest that this alternative term be considered, with essential criteria defining how it should be interpreted.

Linked with our comments on Principle 3 on the inconsistency of wording, the IIF recommends that "*and the banking system as a whole"* in the principle be replaced with *"and the banking system and/or wider financial system"* and that the words *"banking system"* in Criterion 1 and Criterion 5 also be replaced with this wording.

Principle 9: Supervisory techniques and tools

While the IIF supports the proposed changes, the Institute believes that as stated the principle and criteria do not provide either sufficient guidance to the supervisor on how to act in a way that is consistent with international peers, nor the kind of "effective and foreseeable" climate for the firm discussed. While these are only international minima and do not prevent supervisors from going much further, the IIF believes they could be reinforced along the lines of the objectives set out in the 2010 FSB Report.

The Institute also believes that the Core Principles should promote improved and constructive communication and engagement with firms' staff and Boards. This issue was discussed in the 2011 IIF Paper as follows:

"*Positive and effective supervision requires a culture of disclosure, openness, and communication on both sides in which there are no surprises. Firms must ensure that supervisors are not taken by surprise by announcements of material developments of which they could have been apprised at a much earlier stage. Supervisors for their part need to communicate effectively so that perceived deficiencies are shared with the firm before they become the subject of supervisory reports, let alone give rise to early intervention.*"[9]

The IIF would therefore welcome greater guidance on the use of supervisory tools and techniques and the promotion of a culture of disclosure, openness and communication on both industry and supervisors. The Institute would suggest that the Committee consider an additional criterion along the following lines:

The supervisor uses all available tools to regularly review and assess the safety and soundness of banks and the banking system, including horizontal peer and thematic reviews. The supervisor communicates its findings to the bank as appropriate and requires the bank to take action to mitigate any particular vulnerability that have the potential to effect its safety and soundness or the safety and soundness of the banking system. The supervisor uses its analysis to determine follow-up work required, if any.

Linked with our comments on Principles 3 and 8 on the inconsistency of wording, the IIF recommends that the use of "*the banking system"* twice in Criterion 5 be replaced with *"and the banking system and/or wider financial system"*.

Principle 10: Supervisory reporting

The IIF supports the broad direction of the changes to this principle. However, the Institute would encourage development of the criteria in more detail. As stated in the 2011 IIF Paper, we believe that "*it is critical that [supervisors] have access to all relevant data and that firms continuously make best efforts to provide them with this."*

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[9] 2011 IIF Paper p. 29

However, in doing so, the Institute also argued that supervisors should be "*aware of the limitations of data per se, and firms need to be willing to engage in a dialogue designed to explain its content, context, and limitations.*"

The IIF therefore recommends that the criteria be amended and to consider including wording to the effect that:

"*Supervisors have a policy and process in place to ensure that ad hoc data requests:*

- *are well-considered, targeted and proportionate to their objective,*
- *avoid in particular any duplication in relation to mandatory regulatory reporting and data requests from other supervisors, and*
- *are accompanied by clear communication to and, as appropriate, an ongoing dialogue with, concerned banks and banking groups to ensure that the pursued objective is fully understood and, if needed, the request refined or adjusted for more efficient and effective processing taking into account data availability and the banks' or banking groups' IT infrastructure.*

Supervisors have a process (e.g., ad hoc advisory group with broad industry representation, periodic publication and consultation) for communicating and consulting on:

- *evolving data needs and*
- *evolving supervisory expectations regarding data availability and IT infrastructure at banks and banking groups.*

There is evidence that these policies and processes work in practice."

As argued in our comments on Principle 3 above, the Institute also recommends that a criterion be included in one of the two principles to the effect that:

"*Supervisors have policies and processes ensuring effective and efficient coordination cooperation and as appropriate joint supervisory activities with other, in particular relevant home and host, supervisors in normal times and in times of stress. Formal arrangements are in place between supervisors with responsibilities for the same bank or banking group including, in particular, between relevant home and host supervisors. There is evidence that policies and processes and formal arrangements work in practice.*"

This is another area where banks where banks could be asked to report on their experience as part of the assessment process.

Principle 11: Corrective and sanctioning powers of supervisors

The IIF supports the broad direction of the changes here. It is vital that supervisors have sufficient powers to take corrective action and to follow through "*conclusively and in a timely manner*".

Nevertheless, as the Institute has argued, corrective action should be exceptional and at the end of a process of graduated action. Acting "*at an early stage*" does not mean the same as "taking corrective action at an early stage". In Criterion 5, the IIF suggests that "*The supervisor also has the power to intervene at an early stage to"* be replaced with "*The supervisor also has the power to act on a graduated and timely basis"*. As with our comments on Principle 8, the interpretation of "graduated" would need to be defined.

As with Principle 9, there should be greater clarity and definition on the "*relevant authorities*" referred to in Criterion 2 and as with other principles, on how "*at an early stage*" would be interpreted.

Principle 12: Consolidated supervision

The IIF welcomes the efforts that have been made to overhaul and update this principle, and once again, feels that the changes go in the right direction. Nevertheless the revised principle and criteria could still put additional emphasis on the need for coordination and cooperation with other supervisory authorities in the same jurisdiction and with supervisors in third countries.

Furthermore, the issue is not just the duties of the consolidated supervisor but the duties of the supervisors of parts of the group to assist the consolidated supervisor in any way possible. It should not be a question of closing or limiting the operations of a foreign bank if supervision by other supervisors is not adequate or if insufficient information is being passed, but of making best efforts to resolve these concerns – possibly with the mediation of the FSB, BCBS or European Banking Authority – and only if all else fails, penalizing the bank.

The Institute recommends that the essential criteria be fleshed out to refer to the need of a consolidated supervisor to raise any concerns at an early stage and to look to resolve them with the other supervisor. Additional detail in the text would be helpful.

In addition, there are two points where the text is unclear:

i. The meaning of "*contagion and reputation risks*" in Criterion 1; and

ii. The first sentence of new Criterion 7 "*Notwithstanding consolidated supervision, supervisors must not lose sight of the legal status of individual banks in the group."*

The IIF hopes that clarification will be provided on these in the final principles.

Linked with our comments on Principles 3, 8 and 9 on the inconsistency of wording, the Institute recommends that "*the banking system"* in Criterion 1 be replaced with *"and the banking system and/or wider financial system"*.

Principle 13: Home-host relationships

The IIF has consistently argued for greater coordination and a stronger role for colleges. In June 2010, for instance, in response to the consultation on colleges, the Institute argued that they should be given a strong and clear role as bodies with a clear objective of making supervision more effective and efficient. To that end, there should be clear internal accountability within colleges, with supervisors being held to account to follow up on commitments made. The IIF believes the current work provides an opportunity for setting ambitious targets for more effective collaborative work. Colleges should also work toward collective common interpretations of rules, and much greater attention should be paid than in the past to joint working and joint exercises (such as group-wide stress tests), aimed at arriving at a comprehensive and common view of group-wide risk.

As such, the Institute welcomes these changes. Particularly welcome is the insertion at the end of Criterion 4 of "*Home and host supervisors also agree on the communication of views and outcomes of joint activities and college meetings to banks, where appropriate, to ensure consistency of messages on group-wide issues.*"

The IIF, however, believes that the proposed changes might be too limited and fail to promote the kind of effective and efficient collaboration between home and host supervisors that is needed. For instance, the Institute believes that it would be better to make more explicit reference to the "*key reference documents*", such as *FSB Key Attributes for Effective Resolution Regimes* and "*Good practice principles for supervisory colleges*" in the text of the principle and essential criteria, perhaps by specifying that "*The supervisor complies with the attributes set out in […]*".

In view of the extensive clarification needed and the importance of this area, the IIF wonders if splitting the principle into three principles, on home-host cooperation and information sharing in general, on the functioning of colleges, and on the functioning of cross-border crisis management and resolution, would be considered. These are separate aspects of home host cooperation that would be expected to apply differently.

Alternatively, the Institute suggests that at least the existing principle could be reformulated and suggests some more judgmental wording based on our earlier comments on colleges, perhaps in the form of additional criteria for more advanced jurisdictions. The following could be considered:

1. *"For the supervision of banking groups with material cross-border operations the home supervisor has policies and defined processes for close coordination of, and cooperation, and joint supervisory activities with, relevant foreign host supervisors including details of form and frequency of (at least monthly) college-internal communication, (at least quarterly) college meetings, and of a rolling three-year planning process for college-wide supervisory activities. Policies and processes and the college-wide supervisory plan ensure efficient and effective ongoing supervision based upon coordinated, cooperative and joint supervisory activities across all relevant host supervisors and across the full range of supervisory tools and techniques (see Principle 9) including in particular supervisory off-site and on-site work, ad hoc data requests, horizontal reviews, stress tests, and business model and strategy analysis. The home supervisor leads all aspects of college-wide supervisory activities including*

a. *the development, and implementation of the college-wide supervisory plan across all supervisory tools and techniques as projected in the plan, and*

b. *the communication of views and outcomes of college-wide supervisory activities and college meetings to the banking group for all matters related to the parent bank and all material cross-border operations.*

2. *The home supervisor assesses its policies and processes and their effective implementation against evolving international guidance on the functioning of supervisory colleges. It conducts an annual benchmarking exercise against other comparable home supervisors and their policies and processes and implementation thereof."*

The IIF also recommends that the principle or principles make reference to the comments in the 2010 FSB Report, and the 2011 FSB Report on supervision and to earlier guidance on colleges.

The Institute also feels that there should be an explicit linkage between the principle and the assessment methodology. Banks should be asked as part of their assessment for their views on how cooperation and colleges are working.

Finally, we recommend adding a new essential criterion after Criterion 1 in order to strengthen the cooperation and collaboration goals. Such revised text would read:

"The home supervisor leads the college (core, general and all other variable structures). It develops an agreed college mandate that sets out the college's objectives and the college processes for coordination, cooperation and joint supervisory activities including forms and frequency of college-internal communication, annual meeting schedules, and the planning process for college-wide supervisory activities. It oversees the implementation of the college-wide supervisory plan and leads and coordinates the communication of views and outcomes of college-wide supervisory activities and college meetings to the banking group to ensure consistency of messages on group-wide issues."

Principle 14: Corporate governance

The IIF welcomes the emphasis on good corporate governance and is in agreement with the introduction of a new principle on robust policies and processes. This new principle will require supervisors to have adequate resources to carry out a proper assessment of corporate governance policies and processes, and the Institute would like to reiterate the point about the necessity of adequate supervisory resources previously made in comments on Principle 2 above.

In addition, as supervisors enhance their efforts to understand and assess bank strategies the Institute believes that periodic interaction with the Board, and/or with the Board and committee chairs, and/or relevant committees to gain their perspective, and to share and discuss supervisory issues, especially prior to taking formal intervention action, should be more of a priority. It is even more important that supervisors engage Boards directly as supervisors increase their assessment of strategies and business plans. That should be reflected in wording in the essential criteria.

For example, wording could be added to Criterion 2 to the effect that:

"At least for internationally active banks, the supervisor meets periodically with the Board, and separately with chairs of the Board and key committees, to discuss strategy, risk and supervisory issues; and for the supervisor to share perspectives on emerging system-wide risk issues."

In Criterion 3, the Institute suggests adding "*and/or independent members*" after "*experienced non-executive members*".

In addition, although the footnote to Criterion 3 states that the need and mandate of Board sub-committees be commensurate with the bank's risk profile and systemic importance, it is important to note that some banks would not have a separate audit and risk oversight committee, and this structure needs to be accommodated.

The IIF would like to take this opportunity to make a wider point about Board and governance structures. The need for flexibility in corporate governance structures is not limited to the riskiness and systemic importance of a bank, but should also accommodate different corporate structures, such as a two-tier Board, as is acknowledged in Footnote 27 to Core Principle 5.

Footnote 52 to Criterion 5 defines risk appetite as "***the*** (Our emphasis.) *level of aggregate risk that the bank's Board is willing to assume and manage […]*". This formulation suggests that risk appetite can be reduced to one numeric value and that the Board is responsible for managing that risk. Most risk appetite statements contain a mix of several metrics as well as qualitative statements. In addition, the Board is responsible for oversight not management. Therefore, the Institute would suggest that the words "*the level*" and "*manag*e" be removed. If the intention is to note that the risk appetite needs to be commensurate with the bank's ability to measure and manage risk that is already covered in the essential criteria to the principles.

Principle 15: Risk management process

In the '*Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations*',[10] the IIF recommended that:

"*Firms should establish clear policies that define risk management as the responsibility of each institution's senior management, in particular the CEO, subject to the oversight of the Board. Senior management should be involved in the risk-control process, and both the Board and senior management should regard risk management and control as essential aspects of the business.*"

As such, the Institute supports the requirement for a comprehensive risk management process and suggests that more clarity and guidance on the definition of risk appetite would be welcome. In the 2009 IIF Steering Committee on Implementation (SCI) Report,[11] risk appetite was defined as "*the amount and type of risk that a company is able and willing to accept in pursuit of its business objectives*". This is very similar to the BCBS definition of risk appetite in the footnote to Criterion 5 of Principle 14. The IIF Report, Implementing Robust Risk

[10] *2008 IIF CMBP Report*
[11] *2009 IIF SCI Report*

Appetite Frameworks to Strengthen Financial Institutions[12] elaborated on risk appetite statements, suggesting that they "*encompass a suitably wide range of measures and actionable elements*". An additional recommendation is that risk appetite statements include both qualitative and quantitative elements.

The power of the supervisor to require a bank to strengthen risk management processes that it determines are inadequate relative to the inherent risk of particular aspects of the bank's business in former (2006 Core Principles) Criterion 1 seems to have fallen away. This is an essential element in graduated intervention and the IIF suggests that it be reinstated.

Criterion 1 indicates that the Board is to "***ensure***" (Our emphasis.) a variety of matters enumerated in the criterion. The Board's role is oversight and so the use of the word "*ensure*" is not appropriate and the Institute suggests redrafting. As well there appears to be some overlap between parts of these criteria and what is in Principle 14 on corporate governance.

In Criterion 10, requiring larger and more complex banks to have a dedicated risk management unit overseen by a Chief Risk Officer, the IIF recommends adding the requirement that the hiring, firing and compensation of the Chief Risk Officer should formally involve the Board or the Board risk committee.

Principle 16: Capital adequacy

The IIF generally supports this principle as written. However, the Institute suggests that the portion of Footnote 57 to Principle 16 stating that "*capital requirements, at least for internationally active banks, should not be less than the applicable Basel standard*" be reinstated in the principle, as in the 2006 Core Principles. The proposed footnote also indicates that "*The Committee does not consider implementation of the Basel-based framework a prerequisite for compliance with the Core Principles*"

The IIF understands that the Core Principles should not require that a country be on a specific version of the Basel capital standard. The Institute believes that the 2006 wording including that in the introduction accomplishes that result. However, without this wording in the new principle itself, the revised principle seems to downplay the Basel standards, which we believe are very important and need to be implemented consistently to the extent possible. It also seems to leave open the potential of significant derogations from the Basel standards, which G-20 leaders have committed to implement, as long as these are in a country's view "prudent and appropriate".

Principle 17: Credit risk

Criterion 3(a) requires that strategy, policies and processes for assuming credit risk are effectively implemented, without undue reliance on external credit assessments. In its comments on the U.S. ANPR Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies,[13] the IIF noted "*serious reservations as to both the practical feasibility and convenience of fully removing references to credit rating in*

[12] *2011 IIF Risk Appetite Report, p 15*
[13] *IIF ANPR Comments*

risk-based capital guidelines". The IIF pointed out that "*credit ratings are an important market mechanism that cannot prudently be fully dispensed with*."

Although Criterion 3(a) does not recommend fully removing references to credit ratings, the IIF would like to sound a cautionary note on downgrading the use of credit ratings.

On Criterion 6 the Institute suggests that the decision on credit risk exposures, exceeding a certain amount or percentage of the bank's capital or those that are especially risky or not in line with the bank's mainstream activities, could be made at the Board level or by the risk oversight committee in addition to senior management.

Principle 18: Problem assets, provisions and reserves

The IIF supports Core Principle 18 as written and does not have any comments to add.

Principle 19: Concentration risk and large exposure limits

The IIF generally supports this principle as written. The Institute would, however, appreciate clarification that the term "*capital*" in the additional criterion is understood the way it has been traditionally, and that there is no intention of changing this.

Principle 20: Transactions with related parties

There appear to be a number of issues with the reformulation of this principle. First Criterion 1 deals with the issue of the definition of related parties, but references the footnote which covers both related parties and the types of transactions that need to be considered. The IIF suggests splitting these two issues.

The Institute would appreciate understanding whether it is the intention of the BCBS to significantly broaden the definition of related parties and related party transactions, which we are not sure is necessary. As well, wholly owned and controlled subsidiaries of the bank are included in the definition of related parties, but it is difficult to see how transactions with them would necessarily lead to harmful self dealing that needs to be controlled.

In addition, the principle seems to include a variety of intra-group transactions in the normal course of business (e.g. intra-group service contracts or derivative contracts) where fair market values can be hard to determine with exactness, without there being recognition of the need for rules to allow for appropriate discretion by supervisors. The principle indicates that the lists in the footnote are to be "*considered*", and it is not clear therefore what is intended or how the principle will be assessed. It would be better to determine a more limited core list of related parties and types of transactions that should be included in a country's regime and then leave it to individual jurisdictions to decide whether and how to go farther.

Second, in Criterion 2 the changes in wording of the footnote no longer make it clear that low interest loans to employees as part of a remuneration package are not related party transactions.

Third, the footnote to Criterion 5 indicates that "*the concept of connected counterparties is also applicable to related parties*." These two concepts are normally used differently in regulations, and few countries' rules automatically apply related party rules to groups of connected counterparties. The IIF would appreciate clarification of the footnote, and that the revised Core Principles are not changing this approach

Finally, the Institute suggests that the footnote to Principle 20 be broadened to include "*regulators, regulatory officers and politically important persons*" as related parties, or otherwise include them in the principle, to deal with the issue of avoiding any undue influence on bank lending decisions in certain jurisdictions.

Principle 21: Country and transfer risk

The IIF supports Core Principle 21 as written and does not have any comments to add.

Principle 22: Market risk

The IIF generally supports this principle as written, but would appreciate clarification of the requirement in Criterion 5 for the supervisor to determine that banks hold appropriate levels of capital against unexpected losses in the event of significant changes in marked-to-market valuations. As currently drafted it is unclear how this capital buffer relates to other required capital buffers, and whether it could it result in a capital being held against the same risk twice or even multiple times. The Institute would suggest that this reference be dropped as this is an issue already addressed in existing prudential standards.

Principle 23: Interest rate risk in the banking book

The IIF supports Core Principle 23 as written and does not have any comments to add.

Principle 24: Liquidity risk

Criterion 4(d) requires adequate oversight by Boards to ensure that management effectively implements liquidity risk management policies and processes. The IIF believes that this imposes more than the usual duty of oversight on the Board and blurs the roles of management and the Board, and suggests deleting "*adequate oversight by the banks' Boards in ensuring that management*" and changing "*effectively implements policies […]*" to "*effective implementation of policies [...]*"

Criterion 4(d) would read: "*effective implementation of policies and processes for the management of liquidity risk in a manner consistent with the bank's liquidity risk appetite: and*"

Principle 25: Operational risk

The IIF supports Core Principle 25 as written and does not have any comments to add.

Principle 26: Internal control and audit

The IIF supports Core Principle 26 as written and does not have any comments to add.

Principle 27: Financial reporting and external audit

It seems that the requirement for supervisors to "*determine*" that banks and banking groups maintain adequate and reliable records [...], is duplicative given the long standing risk-based supervisory principle of 'reliance' on auditors. Could this lead to a duplication of the supervisor's and external auditor's responsibilities as written?

The IIF suggests rewording Principle 27 to read: "*The supervisor relies on external auditors to determine that banks and banking groups maintain [...]*"

This reliance on auditors should be tested by the supervisor, rather than holding supervisors responsible for determining that, for example, financial statements are prepared in accordance with widely, internationally accepted accounting policies and practices.

Principle 28: Disclosure and transparency

The IIF supports disclosure and transparency and the key role of robust market discipline in contributing to a safe and sound banking system and agrees with expanding the 2006 Core Principle on accounting and disclosure.

As in Principle 27 above, the Institute would insert a cautionary note on the potential duplication of the role of supervisors and external auditors. The supervisor is responsible for assessing disclosure processes; however, there is reliance on auditors to determine required disclosures on financial condition, performance and risk exposures.

The IIF recognizes that the disclosure of risk management strategies, and corporate governance policies and processes are not covered under financial reporting and recognizes their importance in a disclosure framework.

The IIF suggests that providing clarity on where the supervisor may rely on external auditors, and where the supervisor is required to make determinations on disclosures would be helpful for banks.

Principle 29: Abuse of financial services

The IIF supports Core Principle 29 as written and does not have any comments to add.