HIGHER SCHOOL OF ECONOMICS

National Research University

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http://www.hse.ru/en/

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Basel Committee on Banking Supervision

Email: baselcommittee@bis.org

Dear Sirs,

Basel Committee on Banking Supervision Consultative Document
Core Principles for Effective Banking Supervision

On behalf of the National Research University Higher School of Economics (NRU HSE), and particularly the Center for Institutional Analysis, the International Laboratory of Decision Choice and Analysis, the Laboratory of the Banking Institute we would like to thank Basel Committee on Banking Supervision for the opportunity to deliver our opinion on the Consultation Document 'Core principles for effective banking supervision' published by the Basel Committee on Banking Supervision in December 2011 at http://www.bis.org/publ/bcbs213.htm.

The comments are presented in two parts:
(a) 'General Comments' refer to the overall issues related to effective banking supervision;
(b) 'Paragraph-wise Comments' correspond to the particular paragraphs that attracted our attention.

We hope our comments would be of use for deriving financial stability-oriented identification and regulation principles with respect to introduction of proper capital disclosure requirements.

In case of further questions, please, do not hesitate to get in touch through email (dhm-econ@hse.ru), telephone (+7.495.621.13.42, ext. 2006) or fax (+7.495.772.95.90, ext. 2101).

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The document emphasizes the importance of systemic risk analysis and macroprudential regulation. This is an essential step forward in the banking regulation taking into account the events during the recent crisis. The document also stresses the necessity of regulating systemically important banks (SIBs).

General Comments

1. The document lists 29 Principles to evaluate the compliance of a particular country's banking system to the BCBS Standards. Though currently IMF and World Bank are monitoring each of the Principles separately, it is important to have the opportunity of delivering a *standardized* overall banking system compliance evaluation system, because the banking system itself and the level of its development represents the amount of *systemic risk* that it represents to the world economy.

   That is why it is proposed to introduce within the current document the **integral indicator of overall banking system compliance to Principles announced**. It is recommended to assign weights to particular Principle compliance, so that banking systems of different countries are comparable with each other.

2. It is also necessary to determine at least an approximate date when the core principles should be revised. Taking into account the rapidly changing economic environment, it is proposed to re-examine the principles every 3 years.

Paragraph-wise Comments

1. **§16, p. 4: "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"**

   The major problem that became evident during the recent crisis was inappropriately high levels of risk taken by many banks (including off-balance), which is difficult to control. Thus, the primary objective should be the promotion of effective functioning of the banking system where banks act as efficient intermediaries of financial resources. This also includes appropriate risk-taking strategies.
   An important objective is also to avoid the use of taxpayers´ money to cover banking losses.

2. **§16, p. 5: "..supervision should aim to reduce the probability and impact of a bank failure.."**

   The supervision should aim to reduce the impact of a bank failure, not the probability. If a bank is not efficient there is no sense to support it and reduce the probability of its failure.

3. **§21, p. 6: "This broad financial system perspective is integral to many of the Core Principles. For this reason, the Committee has not included a specific stand-alone Core Principle on macroprudential issues."**

   Despite the fact that macroprudential perspective has been included in many Core Principles, it would make sense to have a separate section covering macroprudential issues. This is an important dimension of the banking supervision which should be separately considered.

4. **§25, p. 7: “Such measures may be viewed from two perspectives: (i) the measures to be adopted by supervisory and other authorities (including developing resolution plans and in terms of information sharing and cooperation with other authorities, both domestic and cross-border, to coordinate an orderly restructuring or resolution of a troubled bank); and (ii) those to be adopted by banks (including contingency funding plans and recovery plans) which should be subject to critical assessment by supervisors as part of their ongoing supervision.”**

   It would make sense to exclude the point (i) and retain only (ii). It should be the responsibility of banks to have the necessary restructuring and resolution plans, and not of the government. Moreover, governments in many countries already provide deposit insurance which reduce the impact of banks´ failures. There is no need to spend additional taxpayers´ money to restructure and resolve failing banks.

5. **§35, p. 8: “While the publication of the assessments of jurisdictions affords transparency, an assessment of one jurisdiction will not be directly comparable to that of another...Seeking to compare countries by a simple reference to the number of “Compliant” versus “Non-Compliant” grades they receive is unlikely to be informative.”**

   It is not possible to avoid the comparison of countries based on their assessment and resulting grades. Thus, in order to make the grading more informative all the countries could be grouped based on some characteristics (for example, based on the level of overall economic development, the level of the banking system sophistication and etc.).

6. **§41, p. 10: “Principle 2 – Independence, accountability, resourcing and legal protection for supervisors:..”**

   This principle should also point out that no one within the supervisory authorities has any personal interests in any bank.

7. **§41, p. 11 “Prudential regulations and requirements”**

   This second group of principles should separately include the principle “Currency risk in the banking book” as it is an important type of risk especially for countries with unstable exchange rates.

8. **§41, p. 12 “Principle 25 – Operational risk:..”**

   The principle should also include the following proposition: “In order to ensure an appropriate level of operational risk assessment, the supervisor should collect the necessary data from the banks and create a database (depersonalized) access to which could be provided to all the banks”.

9. **§41, p. 13 “Principle 27 ... banks and banking groups... prepare financial statements... and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor’s opinion.”**

   The word “annually” should be changed on “semi-annually” so that information provided by banks remains up to date because of rapidly changing environment.

10. **§47, p. 14 "The preconditions include:.."**

    The preconditions should also include a separate note on a non-banking sector which has some payment systems and banking functions (e.g. lending).

11. **§50, p. 15 "A well developed public infrastructure needs to comprise the following elements...efficient and effective credit bureaus that make available credit information on borrowers;.."**

    It is also important to create other databases which could help banks more efficiently assess credit, market, operational and other risks. These databases should also be available to the academic community to carry out proper research.

12. **§61, p. 19 "..It is acknowledged that the "gap" between "largely compliant" and "materially non-compliant" is wide, and that the choice may be difficult. On the other hand, the intention has been to force the assessors to make a clear statement."**

    It would make sense to include a grade "partially compliant". Otherwise, as it is mentioned in the document, the gap is too wide. There are a lot of situations when clear statements are not possible, for example, when some supervisory practices are established but not fully implemented yet.

13. **p. 23, Essential criterion 5 for Principle 2: "The supervisor and its staff have credibility based on their professionalism and integrity..."**

    This essential criterion should also point out that the staff has an adequate level of education. For example, only people with higher education could work for regulatory authorities, while for analytical positions people with postgraduate academic degrees are to be preferred.

14. **p. 26, Essential criterion 6 for Principle 5: "A minimum initial capital amount is stipulated for all banks"**

    This minimum capital amount should be the same for existing banks as well. Otherwise, entrance barriers could be created, which would distort the competition in the system.

15. **p. 28, Essential criterion 3 for Principle 7: "Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision."**

    This essential criterion should also emphasize that new acquisitions do not expose the whole system to additional risks and do not distort the market competition.

16. **p. 29-30, Essential criteria for Principle 8:**

    The essential criteria should point out that supervisors should have a well-prepared plan of action with respect to their actions during distress periods.

17. p. 35, Additional criterion 1 for Principle 11: "Laws or regulations guard against the supervisor unduly delaying appropriate corrective actions."

This criterion should be essential rather than additional as a delay of appropriate corrective actions could have significant negative consequences for the whole system.

18. p. 41, Essential criterion 1 for Principle 15: "The supervisor also determines that the Board ensures that:..(c) uncertainties attached to risk measurement are recognised"

This point (c) is not clear and should be explained in more details (if model risk was meant, it is proposed to mention it explicitly).

19. p. 43, Essential criterion 11 for Principle 15: "The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk."

The supervisor should also issue standards related to currency risk in the banking book.

20. p. 45, Additional criteria for Principle 16:

The criteria should emphasize that supervisors have to explain why the minimum capital requirement is set at a particular level.

21. p. 48, Essential criteria for Principle 18:

The criteria should point out that laws, regulations or the supervisor clearly define problem assets and non-performing loans. These definitions should be in line with international standards.

22. p. 48-49, Essential criteria for Principle 18:

The criteria should include a separate clause "The supervisor requires banks to include credit risk analysis into their stress testing programmes for risk management purposes".

23. p. 51, Additional criterion 1 for Principle 19: "In respect of credit exposure to single counterparties or groups of connected counterparties, banks are required to adhere to the following definitions: (a) ten per cent or more of a bank's capital is defined as a large exposure; and (b) twenty-five per cent of a bank's capital is the limit for an individual large exposure to a private sector non-bank counterparty or a group of connected counterparties."

The document should provide the rationale underlying the proposed figures of 10% and 25%.
The paragraph is proposed to be aligned with FSA proposal on large exposure regime (cf. http://www.fsa.gov.uk/library/policy/cp/2012/12-01.shtml).

24. p. 52-53, Essential criteria for Principle 21:

The criteria should include a separate clause "The supervisor requires banks to include country and transfer risk analysis into their stress testing programmes for risk management purposes".
It is also recommended to include a clause (as for Principle 22) "The supervisor determines that banks' strategies, policies and processes for the management of country and transfer risks have been approved by the banks' Boards and that the Boards oversee management in a way that ensures that these policies and processes are implemented efficiently and fully integrated into the banks' overall risk management process".

25. p. 57, Essential criterion 4 for Principle 24: "The supervisor determines that banks' liquidity strategy, policies and processes establish an appropriate and properly controlled liquidity risk environment including:..(e) regular review by the banks' Boards (at least annually) and appropriate adjustment of the banks' strategy,.."

The phrase "at least annually" should be changed to "at least semi-annually" so that the Board has up to date information that is of importance with respect to rapidly changing environment.

26. p. 58-59, Essential criteria for Principle 25:

The criteria should include a separate clause "The supervisor requires banks to include operational risk analysis into their stress testing programmes for risk management purposes".

27. p. 62, Essential criterion 2 for Principle 27: "The supervisor holds the bank's Board and management responsible for ensuring that the financial statements issued annually to the public.."

The word "annually" should be changed to "semi-annually" so that the public has up to date information.

28. p. 63, Essential criterion 2 for Principle 28: "The supervisor determines that the required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, aggregate exposures to related parties, transactions with related parties, accounting policies, and basic business, management, governance and remuneration..."

The information about bank stress-testing results should also be disclosed (standardized scenarios are welcomed to be listed in a separate document to have an opportunity of running consistent benchmarking of stress-testing outcomes for peer-banks).

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