Answer to BCBS Consultative Document

Core Principles
for effective banking supervision

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The proposed revision of the Core Principles for effective supervision is very welcome, but unfortunately misses what should have been its primary target, ie restoring trust among supervisors, as a pre-requisite to counter the worrying trend toward fragmentation.

Instead, the proposal entails a granular list of targeted (and mostly welcome) improvements, making the Core Principles a recipe book for supervisory kitchen…

I urge the BCBS and its members to raise the degree of ambition and face the difficult issue of fragmentation, rather than avoiding it…

As an independent expert with longstanding experience in banking, risk management, and regulation, I welcome the opportunity to answer to the BCBS consultative document on the revision of the Core Principles for effective banking supervision.

This proposed revision is more necessary than ever, given the **significant supervisory failures evidenced in the recent bank turmoil in the US and in Switzerland**. In particular, it is essential to have a debate at international level as to the mandate of bank supervisors, to ensure financial stability, and to develop converging views at global level on questions such as:

- To which extent should supervisors review the sustainability of business models?
- How can supervisors enforce a proper risk culture and governance?
- Are ESG risks part of the mandate of supervisors, and where to draw the line between ESG risks and ESG policies?
- How much harmonization should be targeted as regards Pillar 2, stress testing and capital buffers?
- Etc…

The revision of the 2012 version of the Core Principles is also more necessary than ever, as **the financial ecosystem is more and more interconnected in a digital world**, making supervisory coordination at policy level and in the supervision of large internationally active banks even more crucial than before, to identify and address vulnerabilities that can spill-over in a matter of seconds.

Such coordination has a pre-requisite: **a high degree of trust between authorities**, allowing the sharing of views and data, and allowing to solve problems with in mind the global financial stability as a common good.

Guess what, fostering trust among the global supervisory community is the very essence of the « Core Principles », previously called the « **Basel Concordat** »[1] signed as the first report, in 1975, of the newly created BCBS, established in 1974 as a response to the Herstatt debacle[2].

Hence, my expectations were high when opening the consultative document, and, I must say, **I find this proposed revision extremely disappointing in its scope and level of ambition**.

This revision was put on the BCBS agenda following the recognition by the G20 and the FSB, back already in 2019 under Japanese G20 presidency, that the regulatory and supervisory world was on **a worrying trend toward increasing fragmentation**[3], and that one necessary route to reverse this trend was **to restore trust among supervisors, especially in a home/host context.**

Indeed, the G20 Leaders declared in Osaka in June 2019 that they will address unintended, negative effects of market fragmentation **including through regulatory and supervisory cooperation**.[4]

In October 2020, the FSB published an update[5] on its ongoing work in this area, focusing on :

- **Deference :** The International Organization of Securities Commissions published a Report on Good Practices on Processes for Deference in June 2020 that should help authorities to mitigate the risk of unintended, regulatory-driven, fragmentation in wholesale securities and derivatives markets.

- **Pre-positioning of capital and liquidity**. FSB members are continuing work related to the distribution of resources within global systemically important banks (G-SIB) having regard to the need to achieve a balance between certainty for host jurisdictions and flexibility to deploy resources where needed within a group in times of stress. The FSB is also working on identifying ways to further promote effective cooperation and coordination in crisis times.

- **Regulatory and supervisory coordination and information sharing**. Regulatory and supervisory coordination and information sharing have focused on policy measures taken in response to COVID-19. The FSB has established a repository of regulatory and supervisory policy measures taken in its member jurisdictions in response to the COVID-19 pandemic. The FSB is also exploring potential ways to facilitate convergence in reporting of data to authorities.

- **"Too-big-to-fail" (TBTF) evaluation.** The FSB has publicly consulted on its evaluation on the effects of TBTF reforms for systemically important banks. The evaluation finds no evidence that the implementation of reforms has reduced cross-border lending.

At the time, the industry was fully supportive of FSB's efforts to address market fragmentation, as it faced (and still faces) an accumulation of regulatory and supervisory regimes, including structural reforms such as the Intermediate Holding Company in the US and the Intermediate Parent Undertaking in the EU, creating significant administrative costs and frictions in the allocation of capital and liquidity. In particular, the IIF published a report[6] in January 2019, where

[1] https://www.bis.org/publ/bcbs00a.pdf
[2] https://fr.wikipedia.org/wiki/Herstatt
[3] https://www.fsb.org/2019/06/fsb-publishes-report-on-market-fragmentation/
[4] https://g20.org/en/documents/final_g20_osaka_leaders_declaration.html
[5] https://www.fsb.org/work-of-the-fsb/market-and-institutional-resilience/market-fragmentation/
[6] https://www.iif.com/portals/0/Files/IIF%20FSB%20Fragmentation%20Report.pdf

it suggested several recommendations to « Enhance International Cooperation Among Authorities », **one of those recommendations being, precisely, to revise the Basel Concordat (see p 17).**

The intent to revise the « Core principles » was unveiled in the « Basel Committee work programme and strategic priorities for 2023/24 »[7], endorsed by the GHOS in December 2022[8].

It is surprising that, despite the very clear mandate and focus given to the BCBS by the G20 FSB and GHOS repeatedly since 2019, the consultative document does not address the core issue of trust and supervisory cooperation, but takes a more technical angle, focusing on describing the « best practices » as regards supervision in a given jurisdiction. While the "Core principles" were designed precisely to describe the relationships between supervisors, in particular as regards the supervision of large cross border groups, **it seems that the BCBS has totally lost sight of this extremely important and valuable purpose, and is turning the Core Principles document into an recipe book for good domestic supervision**: « The Core Principles are intended mainly to help countries assess the quality of their systems and to provide input into their reform agenda. » (§20.1).

In my view, not only the consultative document misses what should be its main target, but it shows a complete confusion between regulation and supervision: actually, the effectiveness of regulatory framework should NOT be in the scope of the Principles. Effectiveness of the regulatory framework is dealt with in other processes, namely:

- Quality of implementation in the legal/regulatory framework of the various jurisdictions (RCAP)
- Quality of enforcement (FSAP)
- Evaluation of the relevance of the rules vs market developments, local, structural and cyclical risks :
    - Capacity to identify/anticipate vulnerabilities
    - Adequation of regulatory incentives with sound financing of the economy
    - Evaluation work by the BCBS and FSB

Where the "Core Principles" revision should bring value would be:

1. Updating principles for the **adequate and collaborative supervision of cross border groups**, addressing recent subjects of discussion such as:
    a. functioning of supervisory colleges, including in crisis times
    b. supervision of branches and subsidiaries, principles of equivalence/substituted compliance, potential recourse in case of disagreement? (which could be inspired by the EBA arbitration mechanism)
    c. instead, the document is totally blind on these core issues, avoiding the elephant in the room by stating simply: « **Unless stated otherwise, the "supervisor" refers to the home country supervisor.** » (§22) p 14.

[7] https://www.bis.org/bcbs/bcbs_work.pdf
[8] https://www.bis.org/press/p221216.htm

2. Exploring potential for some **harmonization / best practices as regards the Pillar 2** implementation, an area which creates massive unlevel playing field, maybe even worse than Pillar 1 so-called "deviations".
    a. This part could have been informed by the fundamental, although still inconclusive, work on buffer usability.
    b. Wide structural divergences in the stress testing methodologies also create significant information gaps for market participants, as they are led to compare apples and oranges, in a very opaque process.
    c. Indeed, the Core Principles document is probably the best tool to advance a progressive harmonisation of Pillar 2 practices, and it would be a missed opportunity not to advance this important policy goal.

3. Clarifying the **definition of "large internationally active banks"**, following the recent failures of some US "regional banks".
    a. It is welcome that the US is currently proposing to apply more broadly the prudential framework to banks > 100bn$ in total assets, although the massive pushback by the industry makes the landing point rather uncertain.
    b. It would be BCBS role to accompany this move with a clarification of the intended scope of the framework.
    c. The proposal (§2.12 : Commensurate requirements) rather than encouraging to apply lower requirements to smaller firms, should explicitly recommend simpler but higher requirements due to lower risk-sensitivity.

4. The reference to the IMF FSAP is interesting, and clearly there is room for making those assessments more efficient and consequential.
    a. For example, the review by the IMF of the efficiency of a jurisdiction's regulatory and supervisory framework might be **a robust and neutral input into an equivalence / substituted compliance / deference decisions** (which could also be expanded to the IOSCO-related market regulations).

5. The **crisis management and resolution framework** is core to restoring trust between supervisors.
    a. The Core Principles should also address the sharing of information (in good and bad times) and the need for better coordination in the handling of situations, so that international considerations are better understood, if not considered (eg, treatment of AT1 in the case of Credit Suisse, decision to indemnify uninsured deposits in the case of SVB, etc...).
    b. While the decision will always ultimately rely on the home supervisor or resolution authority, at a minimum, better coordination would help to design adequate and timely communication to limit contagion effects and financial stability risks.

Finally, the concept of « minimum standards » does not apply to supervision. Because, there is nothing like « minimal trust ». Supervision is not about applying a recipe book in a box ticking exercise, but about identifying and mitigating vulnerabilities, known and unknown, in a proportionate manner. The Report by the Expert Group to the Chair of the Supervisory Board of the ECB, published in April 2023, provides very substantive recommendations on how to exercise supervisory judgment, which go much beyond the specific case of the SSM, and could valuably inform the BCBS work.

I hope that the final revision of the Core Principles will address those key issues in a more ambitious way, even if more time is necessary to reach consensus. All the work conducted by the FSB and by the IIF around market fragmentation provides substantial avenues for progress, on which the BCBS could build its new principles. 11 years after the last revision of the Core Principles, it would be a shame that the BCBS misses the opportunity to deliver on its core initial mandate.

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Beyond the above fundamental concerns, please find attached additional comments on the targeted amendments, as track change in the Comparison document. In a nutshell:

1. The inclusion of climate-related risk (to be expanded to ESG, referring to the recent NGFS fundamental work on Nature?) and of the sustainability of business models, as being part of the « safety and soundness » assessment is very welcome. To note, the sustainability of business model is an integral part of the CAMELS framework[9], so it should not be controversial. The issue is rather the extent to which supervisors can take decisions and enforce them, even before capital or liquidity ratios are hit. This part could be expanded.
2. On Home-host relationships and level of application of capital requirements, the CP16 (37) is very unclear and a step in the wrong direction: on a consolidated basis, at every tier (what is a tier?), on a solo level (but not necessarily based on the full suite of international standards?)
3. CP16 (3) Releasability of ADDITIONAL buffers: This is NOT the appropriate answer to the buffer releasability issue. You proposed raising further the capital stack and make the addition releasable. The outcome will be less credit in good times and not more in bad times!
4. On NBFI, there should be a stronger emphasis on the fact that financial stability risks raised by NBFI should be the primary responsibility of those authorities in charge of their licencing and supervision. The indirect impact on banks exposures is only a second order effect.

[9] CAMELS framework: Item Management : Management assessment determines whether an institution is able to properly react to financial stress. This component rating is reflected by the management's capability to point out, measure, look after, and control risks in the institution's daily activities. It covers management's ability to ensure the safe operation of the institution as they comply with the necessary and applicable internal and external regulations.