Basel Committee on
Banking Supervision

BCP

Core Principles for effective banking supervision

BCP30

Preconditions for effective banking supervision

This chapter describes the preconditions for effective banking supervision.

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BANK FOR INTERNATIONAL SETTLEMENTS

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30.1

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 bank regulation and supervision, supervisors should make the government and relevant authorities aware of this and the 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 bank regulation and supervision.

30.2

The preconditions include:

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

30.3

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 or an excessive shortage or supply of liquidity may arise and affect the stability of the financial system. Furthermore, certain government policies[1] may specifically use banks and other financial intermediaries as instruments, which may inhibit effective supervision.

1 Footnote

[1] *Examples of such policies include accumulation of large quantities of government securities; reduced access to capital markets due to government controls or growing imbalances; degradation in asset quality due to loose monetary policies; and government-directed lending or forbearance requirements as an economic policy response to deteriorating economic conditions.*

30.4

In view of the interplay between the real economy and banks and the financial system, it is important that there is 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; for monitoring and analysing market and other financial and economic factors that may lead to accumulation of systemic risks; for formulating and implementing appropriate policies; and for assessing how such policies may affect the banks and the financial system. It should also include mechanisms for effective cooperation and coordination among the relevant agencies.

30.5

Inadequacies in public infrastructure can contribute to the weakening of financial systems and markets or make it difficult to improve them. A well developed public infrastructure needs to comprise the following elements:

1. 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;
2. an efficient and independent judiciary;
3. comprehensive and well defined accounting principles and rules that are widely accepted internationally;
4. 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 that they are prepared according to established accounting principles, with auditors held accountable for their work;
5. availability of competent, independent and experienced professionals (eg accountants, auditors, lawyers and valuers), 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;
6. well defined rules governing, and adequate supervision of, other financial markets and, where appropriate, their participants;
7. secure, efficient and well regulated payment and clearing systems (including central counterparties) for the settlement of financial transactions with counterparty risks effectively controlled and managed;
8. efficient and effective credit bureaus that make credit information available on borrowers and/or databases that assist in the assessment of risks; and
9. public availability of basic economic, financial and social statistics.

30.6

Effective crisis management frameworks and resolution regimes help to minimise 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 basis 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 set out in law to resolve a financial institution that is no longer viable and that has no reasonable prospect of 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 with each other to facilitate planning in advance to handle recovery and resolution situations and to manage such events when they occur.

30.7

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 address the risks to confidence in the financial system and of contagion to otherwise sound institutions while minimising the distortion to market signals and discipline. A key element of the framework for systemic protection is a system of deposit insurance. Provided that 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.

30.8

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. The issues to be addressed include 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.