Basel Committee on Banking Supervision

Consultative Document

Core Principles for Effective Banking Supervision

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Core Principles for Effective Banking Supervision
(The Basel Core Principles)

This document, when finalised, is intended to supersede the 1997 Core Principles for Effective Banking Supervision. Comments on this consultative document are welcome and should be submitted to the Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland by 23 June 2006. Comments may also be submitted by email: baselcommittee@bis.org or by fax: +41 61 280 9100.

Foreword to the review

1. This document is the revised version of the *Core Principles for Effective Banking Supervision*, which the Basel Committee on Banking Supervision (the Committee)[1] originally published in September 1997. Along with the *Core Principles Methodology*,[2] the Core Principles have been used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work to be done to achieve a baseline level of sound supervisory practices. Experience has shown that self-assessments of countries' compliance with the Core Principles have proven helpful for the authorities, in particular in identifying regulatory and supervisory shortcomings and setting priorities for addressing them. The revision of the Basel Core Principles provides an additional reason for countries to conduct such self-assessments. The Core Principles have also been used by the IMF and the World Bank in the context of the Financial Sector Assessment Program to assess countries' banking supervision systems and practices. Since 1997, however, significant changes have occurred in banking regulation, much experience has been gained with implementing the Core Principles in individual countries, and new regulatory issues, insights and gaps in regulation have become apparent, often resulting in new Committee publications. These developments have made it necessary to update the Core Principles and the associated assessment Methodology.

2. In conducting this review of the Core Principles and their Methodology, the Committee was motivated by a desire to ensure continuity and comparability with the 1997 framework. The 1997 framework has functioned well and is seen to have withstood the test of time. Thus the intention was not to radically rewrite the Core Principles but rather to focus on those areas where adjustments to the existing framework were required to ensure their continued relevance. The review does not in any way call into question the validity of previous work already conducted, not least country assessments and reform agendas based on the 1997 framework.

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[1] The Basel Committee on Banking Supervision is a committee of banking supervisory authorities which was established by the central bank Governors of the G10 countries in 1975. It is made up of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent secretariat is located.

[2] In addition to the Principles themselves, the Committee developed more detailed guidance on assessing compliance with individual Principles, in the Core Principles Methodology document, first published in 1999 and also updated as part of this review.

3. Another aim of the review was to enhance – where possible – consistency between the Core Principles and the corresponding standards for securities and insurance as well as for anti-money laundering and transparency. Sectoral core principles, however, are designed to focus on key risk areas and supervisory priorities, which differ from sector to sector, and legitimate differences have to remain.

4. To conduct this review, the Committee acted in close consultation with, and built on the work of, the Core Principles Liaison Group, a working group that regularly brings together senior representatives from Committee member countries, non-G10 supervisory authorities, the IMF and the World Bank. The Committee consulted other international standard-setting bodies – the IAIS, IOSCO, the FATF and the CPSS – during the preparation of drafts. Regional groups of supervisors were invited to comment.[3] Before finalising the text, the Committee conducted a broad consultation that was open to national supervisory authorities, central banks, international trade associations, academia and other interested parties.

The Core Principles

5. The Core Principles are a framework of minimum standards for sound supervisory practices and are considered universally applicable.[4] The Committee drew up the Core Principles and the Methodology as its contribution to strengthening the global financial system. Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. The Committee believes that implementation of the Core Principles by all countries would be a significant step towards improving financial stability domestically and internationally and provide a good basis for further development of effective supervisory systems.

6. The Basel Core Principles define 25 principles that are needed for a supervisory system to be effective. The Principles relate to:[5]

- ***Principle 1 – Objectives, independence, powers, transparency and cooperation:*** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the overall exercise of its duties. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with

[3] The Arab Committee on Banking Supervision, the Association of Supervisors of Banks of the Americas (ASBA), the Caribbean Group of Banking Supervisors, the Committee of European Banking Supervisors (CEBS), the EMEAP Working Group on Banking Supervision, the Group of Banking Supervisors from Central and Eastern European Countries, the Group of French-speaking Banking Supervisors, the Gulf Cooperation Council Banking Supervisors' Committee, the Islamic Financial Services Board, the Offshore Group of Banking Supervisors, the Regional Supervisory Group of Central Asia and Transcaucasia, the SADC Subcommittee of Bank Supervisors, the SEANZA Forum of Banking Supervisors, the Committee of Banking Supervisors in West and Central Africa and the Association of Financial Supervisors of Pacific Countries.

[4] The Core Principles are conceived as a voluntary framework of minimum standards for sound supervisory practices; national authorities are free to put in place supplementary measures that they deem necessary to achieve effective supervision in their jurisdictions.

[5] Further definitions and explanations of the content of the Principles are provided in the document *Core Principles Methodology*.

laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

- ***Principle 2 – Permissible activities:*** The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined and the use of the word "bank" in names should be controlled as far as possible.
- ***Principle 3 – Licensing criteria:*** The licensing authority must have the power to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, and its projected financial condition, including its capital base. Where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.
- ***Principle 4 – Transfer of significant ownership:*** The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.
- ***Principle 5 – Major acquisitions:*** The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
- ***Principle 6 – Capital adequacy:*** Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.
- ***Principle 7 – Risk management process:*** Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.
- ***Principle 8 – Credit risk:*** Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.
- ***Principle 9 – Problem assets, provisions and reserves:*** Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.
- ***Principle 10 – Large exposure limits:*** Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
- ***Principle 11 – Exposures to related parties:*** In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that

banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

- ***Principle 12 – Country and transfer risks:*** Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

- ***Principle 13 – Market risks:*** Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

- ***Principle 14 – Liquidity risk:*** Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

- ***Principle 15 – Operational risk:*** Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and mitigate operational risk. These policies and processes are commensurate with the size and complexity of the bank.

- ***Principle 16 – Interest rate risk:*** Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to their size and complexity.

- ***Principle 17 – Internal control and audit:*** Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

- ***Principle 18 – Abuse of financial services:*** Supervisors must be satisfied that banks have adequate policies and processes in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

- ***Principle 19 – Supervisory approach:*** An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

- ***Principle 20 – Supervisory techniques:*** An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

- ***Principle 21 – Supervisory reporting:*** Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

- ***Principle 22 – Accounting and disclosure:*** Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.
- ***Principle 23 – Corrective and remedial powers of supervisors:*** Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.
- ***Principle 24 – Consolidated supervision:*** An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.
- ***Principle 25 – Home-host relationships:*** Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards required of domestic institutions.

7. The Core Principles are neutral with regard to different approaches to supervision, so long as the overriding goals are achieved. The Principles are not designed to cover all the needs and circumstances of every banking system. Instead, specific country circumstances should be more appropriately considered in the context of the assessments and in the dialogue between assessors and country authorities.

8. National authorities should apply the Principles in the supervision of all banking organisations within their jurisdictions.[6] Individual countries, in particular those with advanced markets and institutions, may expand upon the Principles in order to achieve best supervisory practice.

9. A high degree of compliance with the Principles should foster overall financial system stability; however, this will not guarantee it, nor will it prevent the failure of individual banks. Banking supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are part of risk-taking.

10. The Committee stands ready to encourage work at the national level to implement the Principles in conjunction with other supervisory bodies and interested parties. The Committee invites the international financial institutions and donor agencies to use the Principles in assisting individual countries to strengthen their supervisory arrangements. The Committee will continue to collaborate closely with the IMF and the World Bank in their monitoring of the implementation of the Committee's prudential standards. The Committee is also committed to further enhancing its interaction with supervisors from non-G10 countries.

[6] In countries where non-bank financial institutions provide deposit and lending services similar to those of banks, many of the Principles set out in this document would also be appropriate to such non-bank financial institutions. However it is also acknowledged that some of these categories of institutions do not necessarily have to be supervised in the same manner as banks as long as they do not hold, collectively, a significant proportion of deposits in a financial system.

Preconditions for effective banking supervision

11. An effective system of banking supervision needs to be based on a number of external elements, or preconditions. These preconditions, although mostly outside the direct jurisdiction of the supervisors, have a direct impact on the effectiveness of supervision in practice. Where shortcomings exist, supervisors should make the government aware of these and their actual or potential negative repercussions for the supervisory objectives. Supervisors should also react, as part of their normal business. These external elements include:

- sound and sustainable macroeconomic policies;
- a well developed public infrastructure;
- effective market discipline; and
- mechanisms for providing an appropriate level of systemic protection (or public safety net).

12. Sound macroeconomic policies must be the foundation of a stable financial system. This is not within the competence of banking supervisors. Supervisors will, however, need to react if they perceive that existing policies are undermining the safety and soundness of the banking system.

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

- a system of business laws, including corporate, bankruptcy, contract, consumer protection and private property laws, which is consistently enforced and provides a mechanism for the fair resolution of disputes;
- comprehensive and well defined accounting principles and rules that command wide international acceptance;
- a system of independent audits for companies of significant size, to ensure that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;
- an efficient and independent judiciary, and well regulated accounting, auditing and legal professions;
- well defined rules governing, and adequate supervision of, other financial markets and, where appropriate, their participants; and
- a secure and efficient payment and clearing system for the settlement of financial transactions where counterparty risks are controlled.

14. Effective market discipline depends, in part, on adequate flows of information to market participants, appropriate financial incentives to reward well managed institutions, and arrangements that ensure that investors are not insulated from the consequences of their decisions. Among the issues to be addressed are corporate governance and ensuring that accurate, meaningful, transparent and timely information is provided by borrowers to investors and creditors. Market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives. In these circumstances, it is important that, if guarantees are provided for such lending, they are disclosed and arrangements are made to compensate financial institutions when policy loans cease to perform.

15. In general, deciding on the appropriate level of systemic protection is a policy question to be addressed by the relevant authorities (including the central bank), particularly where it may result in a commitment of public funds. Supervisors will normally have a role to play because of their in-depth knowledge of the institutions involved. It is important to draw a clear distinction between this systemic protection (or safety net) role and day-to-day supervision of solvent institutions. In handling systemic issues, it will be necessary to address, on the one hand, risks to confidence in the financial system and contagion to otherwise sound institutions and, on the other hand, the need to minimise the distortion to market signals and discipline.[7] In many countries, the framework for systemic protection includes a system of deposit insurance. Provided such a system is carefully designed to limit moral hazard, it can contribute to public confidence in the system and thus limit contagion from banks in distress.

[7] See BCBS, *Supervisory guidance on dealing with weak banks*, March 2002.