

**Submission for the G-7 Heads of Government
at the June 1997 Denver Summit**

**STRENGTHENING
BANKING SUPERVISION
WORLDWIDE**

**Recent Initiatives of the
Basle Committee on Banking Supervision**

**Basle
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Strengthening banking supervision worldwide

This report summarises the recent work of the Basle Committee on Banking Supervision and highlights several significant achievements, which are presented in more detail below. These achievements include:

- **fostering global financial stability and strengthening relationships with banking supervisors from non-G-10 countries through the development of the Basle "Core Principles for Effective Banking Supervision"**. This document will contribute significantly to the adoption of strict prudential standards worldwide, particularly in emerging market economies. (See Section IA)
- enhancing supervisory understanding of specific topics through the release of a **Compendium of approximately thirty-five texts published by the Committee** to support the Core Principles by providing more in-depth guidance to supervisors in all countries on specific topics. (See Section IA)
- worldwide endorsement of **the report on Supervision of Cross-border Banking** prepared by a joint working group of the Basle Committee and members of the Offshore Group of Banking Supervisors. This paper contains twenty-nine recommendations aimed at removing obstacles to the implementation of effective consolidated supervision. (See Section IB)
- **enhancing cooperation among banking, insurance and securities supervisors**. (These are briefly described in Section II below and more extensively in a separate document submitted by the Joint Forum on Financial Conglomerates and signed by the Chairmen of the three constituting parent Committees.)
- continued **promotion of international banking soundness** through improved capital standards. (See Section IIIA)
- release of a paper on **the management of interest rate risk**, which re-emphasises the need for banks to maintain adequate risk management practices and establishes twelve principles that the Committee's members will use as standards in evaluating the effectiveness of banks' management of interest rate risk. This paper is currently out for consultation. (See Section IIIB)

- refocusing **Committee sub-groups** to address **risk management and internal controls, and information** and the creation of a **task force on accounting issues**. These groups, dealing with several crucial qualitative issues, have already initiated work in their respective areas. (See Sections IIC and IID)
- addressing the **supervisory issues arising from banks' participation in payment systems and electronic money and banking**. (See Section IV)
- increased **supervisory training** by the Basle Committee Secretariat with assistance from individual Committee members. (See Section IC)

The Committee is confident that its recent work is supportive of the four main initiatives of G-7 Heads of Government enumerated in the Lyon Summit Communiqué.

I. Strengthening prudential standards in emerging countries

A. Development of Core Principles for Effective Banking Supervision and the Compendium of existing Basle Committee documents

In recognition of the fact that weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally, the Basle Committee has recently examined how best to expand its efforts with regard to strengthening prudential supervision in all countries by building on its prior work. In September 1996, the Committee decided to prepare two separate products: (1) a comprehensive set of Core Principles for Effective Banking Supervision applicable in both G-10 and non-G-10 countries; and (2) a Compendium which brings together the existing Basle Committee recommendations, guidelines and standards. Both documents have now been endorsed by the G-10 central bank Governors. The Core Principles have been released as a consultative paper and it is anticipated that the document will be finalised by September of this year.

The document sets forth twenty-five basic Principles that must be in place for a supervisory system to be effective. The Principles relate to seven broad topics:

1. Pre-conditions for effective banking supervision. An effective system needs clear responsibilities, objectives and operational independence for each supervisory agency, a suitable legal framework, and arrangements for sharing information between supervisors.

2. Licensing and structure. The licensing process for banks should, at a minimum, consist of an assessment of the bank's ownership structure, management and operating plans. Controls on the permissible activities of such institutions must be clearly defined.

3. Prudential regulations and requirements. No internationally active bank should be subject to capital requirements of less than 8% in relation to risk-weighted assets, as defined in the Basle Capital Accord, and all types of banks should be subject to capital requirements. Concentration of risks and connected lending should be effectively monitored and controlled, as well as other kinds of banking risks. Adequate practices and procedures that promote professional standards in the financial sector are also required, in order to prevent banks from being used by criminal elements.

4. Methods of on-going banking supervision. An effective banking system should consist of some form of both on-site and off-site supervision.

5. Information requirements. Each bank must maintain adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition and profitability of the bank and must publish regular financial statements that fairly reflect its condition.

6. Formal powers of supervisors. Banking supervisors must possess adequate supervisory powers to enforce corrective action where necessary.

7. Cross-border banking. Banking supervisors must practise global consolidated supervision and must have powers to share information needed for this purpose.

The Principles are minimum requirements and in many cases they may well need to be strengthened or complemented to address particular conditions and risks in the local financial system.

The Core Principles are intended to serve as a basic reference point for supervisory and other public authorities in all countries. It will be for national supervisory authorities, many of which are actively seeking to strengthen their current supervisory regime, to use the Principles to initiate a programme designed to address any deficiencies as quickly as is practical. This will require legislative changes where necessary. The Principles have also been designed to be verifiable by supervisors, their regional groups, and the market at large.

In developing the Principles, the Basle Committee has worked closely with non-G-10 supervisory authorities. The document has been prepared in a joint group containing representatives from the Committee as well as Chile, China, Czech Republic, Hong Kong, Mexico, Russia and Thailand. Eight other countries (Brazil, Hungary, India, Indonesia,

Korea, Malaysia, Poland and Singapore) have also been closely associated with the work. Banking supervisors from these fifteen countries agree with the content of the present document. Moreover, the Principles have benefited from broad consultation with a larger group of individual non-G-10 supervisors, both directly and through the medium of the regional supervisory groups, as well as with the IMF and World Bank.

Following the wider consultation process, supervisory authorities throughout the world will be encouraged to make a formal endorsement of the Principles. Implementation would include a review of the current status of existing supervisory arrangements and, where supervisory arrangements are inconsistent with the Principles in any material respect, establishing a time frame to address the deficiencies. Implementation of the Principles will be surveyed by the Basle Committee and reviewed at the International Conference of Banking Supervisors in October 1998 and bi-annually thereafter.

The Compendium of existing Basle Committee recommendations, guidelines and standards will be published together with the Core Principles. The Compendium will serve as a companion piece to the Core Principles in that existing Committee documents elaborate on many of the Principles. In such instances, the Core Principles document clearly cross-references documents contained in the Compendium.

The Basle Committee believes that achieving consistency with the Core Principles in every country would be a significant step in the process of improved financial stability domestically and internationally. However, the speed with which this objective will be achieved will vary and in many countries depends, in large part, on necessary substantive changes in the legislative framework and in the practical powers of supervisors.

B. Improvements in the supervision of cross-border banking

At the International Conference of Banking Supervisors in June 1996, organised by the Basle Committee, the representatives of about 140 countries endorsed a report on the Supervision of Cross-border Banking prepared by a joint working group of the Basle Committee and members of the Offshore Group of Banking Supervisors. This marked a significant step in further strengthening cooperation among banking supervisory authorities. The paper contains twenty-nine recommendations aimed at removing obstacles to the implementation of effective consolidated supervision. In particular, it reinforces the principle that (subject to suitable safeguards) home country supervisory authorities should have full access to necessary information, and sets out ways in which they can conduct cross-border inspections at branches or subsidiaries owned by banks headquartered in their jurisdictions.

The Committee believes that the implementation of the recommendations contained in the report will facilitate the supervision of cross-border banking activities; however, as with the Core Principles, changes in national legislation will be required in many countries. Discussions regarding these changes are already being conducted in some centres.

C. The network of worldwide supervision

The Basle Committee has recently taken further steps in building a truly worldwide network of banking supervisors and promoting the dissemination of Basle Committee documents, recommendations, guidelines and standards. Two new initiatives are:

- the Committee has started to hold joint meetings with groups of banking supervisors from non-G-10 countries during all of its quarterly meetings; and,
- there has been a significant increase in the resources devoted to supervisory training by the Basle Committee Secretariat. In addition, the Committee is working with the IMF and World Bank on mutual participation in each others' training programmes for banking supervisors.

It is also important to stress the ways in which supervisory authorities continue to benefit from the ongoing work of the Basle Committee. These include:

- a biennial international conference for supervisory authorities in all countries of the world, organised by the Basle Committee; preparations have already begun for the tenth such conference to be held in October 1998;
- the maintenance and regular circulation of an up-to-date contact list of banking supervisory authorities worldwide;
- support for regional supervisory groups as a means of encouraging national supervisory efforts through regional information-sharing and development of regional policies;
- the organisation of several week-long training courses annually for banking supervisors, either in Basle or in regional centres, and the active participation of the Basle Committee Secretariat in supervisory training courses organised by the IMF and World Bank;

- the availability of the Basle Committee Secretariat as a continuous source of assistance and advice on supervisory policies.

The Basle Committee continues to review its efforts in this area and to expand its outreach wherever possible.

II. Enhanced cooperation across markets to strengthen supervision of financial institutions

The Committee views the work of the Joint Forum on Financial Conglomerates as a principal element of its efforts to enhance cooperation with securities and insurance supervisors so as to strengthen the supervision of financial institutions. The Committee fully supports and continues to participate actively in the Joint Forum's examination of complex supervisory issues arising from the activities of internationally active financial conglomerates.

The recent accomplishments of the Joint Forum are detailed in a separate report being submitted by the Basle Committee, IOSCO and the International Association of Insurance Supervisors. However, a few key points warrant special mention.

Firstly, in accordance with its mandate, the Joint Forum has been pursuing practical means to facilitate the exchange of information among supervisors, both domestically and internationally and has recently identified legal and other impediments to such exchanges, several of which appear not to be justified and which it advocates removing.

Secondly, a Task Force of the Joint Forum has been conducting an analysis of thirteen international financial conglomerates in order to enhance the understanding of the ways in which such groups are managed and organised. This experience has identified structural, operational and risk management issues which are being explored in parallel with current supervisory arrangements for such groups. It is anticipated that this effort will assist the Joint Forum in finding ways to enhance communication among supervisors and in preparing principles for information-sharing.

Thirdly, the Committee recognises the work of the Joint Forum on developing principles of supervision, particularly on elaborating techniques of group-wide capital measurement to assist in the supervision of the regulated entities within the group. Progress in these areas is important to identify steps which may need to be taken to strengthen the supervision of institutions which form parts of financial conglomerates.

III. Stronger risk management and improved market transparency

A. Promotion of international banking soundness through improved capital standards

With regard to capital adequacy standards, the Basle Committee is currently overseeing the implementation of the January 1996 Amendment to the Capital Accord to incorporate market risks. The Amendment, which will take effect no later than the end of 1997, requires banks to calculate their market-risk capital charges using one of two methods: a standardised measurement or an approach based on the results of internal models. The latter method allows banks to use risk measures derived from their own internal models, subject to a defined set of qualitative and quantitative standards. The Amendment is designed to ensure that banks hold a prudent level of capital against the risks associated with their trading activities and to reinforce banks' efforts to improve risk management techniques vis-à-vis their overall market activities.

Since the Amendment was agreed, the Basle Committee has conducted further work regarding the impact of the two approaches on banks' capital requirements. The results, which were reviewed last November, confirm the Committee's view that the internal models approach appropriately recognises the benefits of risk diversification strategies and provides incentives for firms to enhance the soundness and precision of their internal models on an ongoing basis. The Committee expects banks to make further advancements in the modelling and coverage of complex components of market risk. Accordingly, the Committee is continuing its work with the industry.

B. Issuance of a paper on the management of interest rate risk

The Committee issued in January a paper concerning the management of interest rate risk, which re-emphasises the need for banks to maintain adequate risk management practices and establishes twelve principles that the Committee's members will use as standards in evaluating the effectiveness of banks' management of their interest rate risk. The principles encompass oversight by the board and senior management, adequate policies and procedures for managing the risk, the system for measurement and monitoring of the risk, the comprehensiveness of controls, and the methods to be used by supervisory authorities to monitor interest rate risk. The paper is currently going through a consultation process and it is anticipated that it will be finalised at the end of the summer.

C. Refocusing Committee sub-groups

In recognition of the need to enhance further risk management and market transparency, the Basle Committee has recently refocused the work of two of its sub-groups to address risk management and internal controls, and information. Key reasons for this restructuring were the critical importance of stronger internal controls within firms as well as more reliance on market information.

The Sub-group on risk management and internal controls will develop guidance for supervisors and encourage sound industry practices across a broad range of risk management and internal control topics. The first priority of the Sub-group will be the development of a sound practices paper on internal controls.

The mission of the Sub-group on Information is to enhance market discipline, and to promote efficient markets and effective banking supervision by improving the information available to assess the risks inherent in individual banking institutions. The Sub-group will focus on reporting and public disclosure issues, including analysis of the role of public disclosure, the identification of information "gaps" and the provision of guidelines. The sub-group is also considering an expansion of the reporting framework for derivative activities, defined in collaboration with IOSCO to include market risk.

D. Accounting issues

A Task Force on accounting has been created to address a range of accounting issues. Accounting standards are of critical importance to banking supervisors as they directly determine the measurement of a bank's capital and are the key to accurately reflecting the current financial position and performance of banks. Without realistic and consistent accounting standards and practices, efforts to promote disclosure by banks will be less meaningful. Over the coming months, the priorities of the Task Force will be: (1) to work with the International Accounting Standards Committee (IASC) and other relevant bodies in matters affecting bank accounting; (2) to conduct a broad survey of current accounting policies and practices applied to banks in G-10 countries; and (3) to focus on policies and practices for loan valuation, provisioning and related matters so as to understand better the current accounting treatments and to determine what guidance can be given to enhance accuracy and comparability.

IV. Supervisory issues arising from banks' participation in payment systems and electronic money and banking

The Basle Committee is currently identifying supervisory issues raised by banks' participation in payments systems as well as electronic money and banking. The Committee is drawing on ongoing work being carried out at the Bank for International Settlements and other international forums.

On *payment systems*, work is being done by the joint task force established between the Basle Committee and the G-10 Committee on Payment and Settlement Systems (CPSS) to consider issues of joint interest to banking supervisors and those in the G-10 central banks responsible for payment and settlement systems. Although payment systems' oversight and banking supervision have followed different approaches in the past, their shared goal of enhancing financial stability in the present fast-changing environment has resulted in recent substantial convergence, primarily in four fields. These are:

- efforts to develop international cooperation to deal with cross-border activities;
- emphasis on the need for improved market discipline, through transparency and disclosure;
- the supervisory treatment of loss-sharing and liquidity arrangements of clearing systems, multilateral netting schemes, better assessment and management of settlement risk, and collateral management; and,
- more stringent requirements in relation to risk management and internal controls.

On this last point, the joint working party is in the process of developing a set of questions to be used as a supervisory tool by bank examiners or auditors. The purpose is to evaluate whether bank managers are aware of the risks relevant to their participation in various payment/clearing/netting/settlement systems and how they measure and manage those risks.

On *electronic money* and *electronic banking*, the Basle Committee has conducted a preliminary analysis of the implications for banks both in terms of the various risks posed for banks and also in terms of the supervisory issues. The Committee is aware of the need to strike a balance between fostering innovation by not regulating too much or too soon, and resolving uncertainty and reducing risks by not waiting too long. An interim note describing the possible areas of concern was forwarded to the G-10 Deputies Working Party on Electronic Money in January 1997. The main supervisory issues identified include: risk management and internal controls, capital standards, issuer liability, cross-border activities, and outsourcing risk. The note also stresses that, in addition to these direct supervisory issues,

there are several other issues that are relevant for banking supervisors to consider, notably criminal law issues, consumer protection, deposit insurance, and provider issues. The Committee intends to study these issues in the coming months with a view to having a report available by the end of 1997, while constantly monitoring the rapidly changing situation. This report will also present an update of the recent developments related to e-money and e-banking in G-10 countries (drawing on the work of other international groups) and explore the need for possible supervisory guidance in this area.

V. Conclusion

During the last year the Basle Committee has done much work and accomplished many important tasks for improving financial stability domestically and internationally. Its priorities are fully consistent with those of the G-7 Heads of Government and Ministers as set out in the Lyon Summit Communiqué. However, banking supervisors alone cannot create all the conditions necessary for sound banking - they also need to operate in an environment which enables supervisory methods to be capable of effective application.

Specifically, the work of the Committee in elaborating the Core Principles and the report on the Supervision of Cross-border Banking has identified certain legal impediments which should be eliminated to facilitate work going forward. In countries where supervisory authorities do not at present have the statutory powers and/or lack sufficient autonomy, including financial autonomy, to (1) implement the Core Principles or the recommendations in the Cross-border Banking report or (2) share information with other supervisors, it is essential that national legislators give consideration to the changes necessary. The influence of G-7 Heads of Government and Ministers could be beneficial to the process of addressing impediments to effective supervision where they exist.

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