INTERNATIONAL MONETARY FUND AND THE WORLD BANK

NOTE TO THE EXECUTIVE BOARDS OF THE IMF AND THE WORLD BANK ON THE REVISED BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

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GLOSSARY

BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principles for Effective Banking Supervision
CP	Core Principle
CPLG	Core Principles Liaison Group
CPSS	Committee on Payment and Settlement Systems
EU	European Union
FATF	Financial Action Task Force
FSAP	Financial Sector Assessment Program
FSI	Financial Stability Institute
IAIS	International Association of Insurance Supervisors
ICBS	International Conference of Bank Supervisors
IFI	International Financial Institution
IOSCO	International Organization of Securities Commissions
KYC	Know Your Customer
MCM	Monetary and Capital Market Department
ROSC	Report on Observance of Standards and Codes
TA	Technical Assistance
WAMU	West Africa Monetary Union

I. Introduction

1. In October 2006, the Basel Committee on Banking Supervision (BCBS) issued a revision of the 1997 Basel Core Principles for Effective Banking Supervision (BCP) and the associated 1999 assessment “Methodology.”[1] The revised text was endorsed by the International Conference of Banking Supervisors (ICBS) during its meeting in Merida, Mexico, in October 2006. This conference was attended by bank supervisors from central banks and supervisory agencies from 120 countries. The BCP, conceived as a framework of minimum standards for sound practices for supervisory and other public authorities in all countries, are seen as the authoritative global standard for effective banking supervision. The BCP assessment is a key element in the Financial Sector Assessment Program (FSAP) and the Reports on Observance of Standards and Codes (ROSCs).

2. The purpose of this note is to inform the Executive Boards of the World Bank and the IMF of the main changes in the BCP and assessment Methodology. Due to differences in the Bank and Fund Board procedures, this paper is being submitted by the Bank staff to its Board for information purposes only, advising the Board that the revised BCP and assessment Methodology will be used as the standard for future BCP assessments. However, in the case of the IMF, Fund staff is seeking the concurrence of its Board for the use of the revised BCP as the standard for future BCP assessments.

3. The objective of the BCBS with the revision of the BCP is to ensure their continued relevance as a globally applicable standard. The mandate of the BCBS for the revision specified that it should not introduce new supervisory issues or standards that have not been previously endorsed by BCBS. It was to be as limited as possible while still achieving the BCBS’s objective, and include only established guidance and insights. In conducting the revision, the BCBS has also aimed to ensure continuity and comparability with the 1997 BCP. It also recognized the need to retain the BCP’s flexibility as a standard for both advanced and less advanced banking systems.

4. While the number of principles remains at 25, the focus of the principles has been sharpened. Many of the revisions have been implemented by adding or changing assessment criteria in the “Methodology.” The revisions of the BCP incorporate key elements of guidance papers issued by the BCBS since 1997, mainly in the management of banking risks, as well as insights gained by the Bank and the Fund in their BCP assessments of over 130 countries since 1998.

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[1] Core Principles Methodology, Basel Committee on Banking Supervision, Basel, October 1999.

Box 1. Summary of Main Changes in the BCP

- More emphasis has been placed on governance, transparency and accountability of supervisory agencies, and reaffirming supervisory independence and adequacy of resources and legal protections.

- Bank governance has been given more attention to ensure that there is effective control over a bank's entire business. More details are provided on board and senior management responsibilities as well as the need to set clear strategies and accountabilities for implementing them.

- Strengthened guidance on risk management practices is provided**.** While some areas were already covered in the former BCP, these have now been brought under "standalone" CPs. These include (i) an integrated approach to risk management, (ii) liquidity risk, recognizing its role in causing banking distress, (iii) operational risk and (iv) interest rate risk in the banking book.

- The importance of greater disclosure as a means to enable market discipline to supplement official supervision is reinforced**.** New criteria have been added specifying that the supervisor should now "require" disclosure and not just "promote" it, as formulated earlier.

- The "know-your-customer" (KYC) principle has been expanded to better capture issues pertaining to the abuse of financial services firms by criminal elements as reflected in the revised FATF standards as far as relevant for bank supervisors. Accordingly, new assessment criteria have been added to the BCP Methodology, and KYC rules are to be integrated into banks' overall risk management processes.

- Increased attention has been paid to cross-border banking issues, through requirements both to carry out effective consolidation supervision and to have in place specific arrangements for cooperation and information sharing between home and host supervisors for both normal times and crisis situations.

- The Methodology provides more guidance to assessors on how they should address the "preconditions" for effective banking supervision, (i.e., sound macroeconomic policies, developed public infrastructure, effective market discipline, and public safety nets) which are usually outside the control of bank supervisors. The objective is that readers of the assessment are better able to understand the conditions under which supervision operates in the country, and that local supervisors are made aware of weaknesses so they can take compensatory measures.

- The implementation of Basel II[2] is not a prerequisite for compliance with the BCP. The revised BCP require Basel II compliance only from those countries which have declared that they have implemented Basel II in their supervisory systems.

5. Much effort was taken to assure an inclusive and transparent revision process. The non-G10 members of the Core Principles Liaison Group (CPLG)[3] have been given several

[2] Basel II is the revised capital adequacy framework—"International Convergence of Capital Measurement and Capital Standards" issued by BCBS in June 2004.

[3] CPLG members: Argentina, Australia, Brazil, Czech Republic, China, Chile, United Kingdom, France, Germany, Hong Kong, India, Italy, Japan, Korea, Mexico, Netherlands, Poland, Russia, Saudi Arabia, Singapore, South Africa, Spain, United States, FSI, WAMU, EU, IMF, World Bank.

opportunities to comment and submit suggestions. Two rounds of external consultation have been held, one for other standard setters, in particular the IAIS, IOSCO, CPSS, and FATF [4] as well as the regional groups of bank supervisors, and one for the public at large, including industry and academia. The Fund and the World Bank have participated fully in the revision process, including the drafting of the document. Box 1 summarizes the main changes.

6. The press release issued by the BCBS at the time of endorsement of the revised BCP specifies that the revised BCP are immediately available as the basis for Bank and Fund assessments, without a transitional period. The BCBS has recognized, however, that implementation of the changes in the BCP in national jurisdictions might take time and that the Bank and the Fund will reflect this in their assessments. For assessments underway, the former text of the BCP will continue to be used.

7. Nevertheless, as in the 1997 BCP, the revised text stresses that the objective of the assessments is not to focus on weaknesses, but to identify opportunities for improvement. Areas needing attention are to be incorporated into an action plan that is provided to the authorities after the assessment has been completed, to assist them to move towards full compliance. BCP assessments based on the revised BCPs, however, combined with an increased emphasis on actual implementation and enforcement, may negatively affect gradings, at least over the near-term as countries adjust their supervisory systems to the revised BCP. Moreover, it is expected that the Bank and the Fund's assessments of member's bank supervisory system will become more complex and resource intensive.

8. This note is structured as follows**:** After the Introduction, Section II discusses the structure of the revised BCP and Methodology; Section III highlights changes that have been made to the document. Section IV explains how the revised BCP will be used for assessments. Section V explores the nature of the technical assistance that could be provided to our member countries. Section VI discusses actions that the Bank and Fund have taken to develop additional criteria to conduct Basel II compliance. Section VII discusses the resource implications for Bank/Fund work in surveillance and technical assistance. Section VIII requests endorsement of the use by Bank and Fund staff of the revised BCP as the standard on which to assess countries' banking supervision systems and practices.

II. Structure of the New BCP and Methodology

9. Since 1997, substantial innovations and developments have taken place in financial institutions and markets, and, in response, in supervisory practices. The internationalization of markets and institutions, their expansion in volume and product mix, and the emergence of many more cross-border financial conglomerates have changed the financial landscape. The

[4] International Association of Insurance Supervisors, International Organization of Securities Commissions, Committee on Payment and Settlement Systems, Financial Action Task Force.

standard setters have responded by issuing additional guidance, for instance on, liquidity management, management of interest rate risk, operational risk, internal and external audit, cross-border supervision of banks, bank governance and integrity of banking operations.

10. Building on this, the supervisory community generally agreed that it is important for banks to enhance their risk management process and for supervisory agencies to better coordinate cross-border cooperation and supervisory transparency, all of which require robust baseline supervision. These new developments required a review of the continued relevance of the BCP as the international benchmark for effective banking supervision. In helping to define the scope of the revision, the BCBS's Core Principles Liaison Group considered the main findings from the Bank and the Fund's BCP assessments as possible areas to include in the revision of the BCP.

11. The structure of the revised BCP remains broadly unchanged. The preconditions, which are not part of the compliance assessment, but are reviewed by the assessors in a qualitative way to provide background to the actual BCP assessment, have not changed substantively, except for the deletion of effective resolution of problem banks. This topic has been adequately covered in CP 23. CP1 has been amended to deal with the foundations of effective supervision: clarity of responsibilities and objectives, resources and independence, legal framework and enforcement powers, legal protection for supervisors and information sharing among supervisors at home and abroad. CPs 2-5 deal with bank ownership, licensing and business activities, CPs 6-18 address capital adequacy and risk management, internal systems and combating abuse of banks by criminal elements. CPs 19-22 cover off-site and on-site supervision, as well as reporting and accounting issues. CP 23 discusses corrective and remedial powers, and CPs 24 and 25 deal with supervision of cross-sector and cross-border banking.

12. Within the limit of 25 principles, space for new CPs was created by merging some of the existing principles. A new "umbrella" principle on risk management has been introduced, covering common aspects of different risk types and requiring banks to establish an integrated approach to risk management. Additionally, specific principles were drafted for liquidity risk, interest rate risk in the banking book[5] and operational risk. These risks were earlier bundled together in one CP but due to their increased importance they are now treated in more detail in separate CPs.

13. The Methodology has been expanded to include more detailed assessment criteria, to "upgrade" certain criteria from "additional" (i.e., best practices not to be used as a basis for a "grading") to "essential" criteria to reflect increased importance of certain implementation aspects. The "IFI Annex" has been redrafted to reflect current FSAP practice and to provide more guidance for review of the preconditions.

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[5] Banks' non-trading activities.

III. MAIN REVISIONS TO THE BCP AND METHODOLOGY

A. Supervisory Governance, Transparency, Accountability, and Legal Protection

14. The revised BCP place more emphasis on governance, transparency and accountability of the supervisory authority. The revised BCP require the responsibilities, independence and accountability arrangements of the supervisory authority to be clearly defined and publicly disclosed. Supervisory accountability is to be achieved through a "transparent framework" for the discharge of its duties. This enrichment of the BCP may allow for the elimination of separate assessments of banking supervision transparency under the Fund's Code of Good Practices on Transparency of Monetary and Financial Policies.[6] The proper exercise of supervision is further strengthened by the requirement of legal protection for supervisors. While this requirement is not new, assessment criteria now specify for the first time that legal protection for actions and/or omissions made while discharging supervisory duties in good faith, must be laid down in law, and must also include protection against the cost of legal defense. More guidance is also provided on what is meant by "adequate supervisory resources."

B. Ownership, Licensing, and Other Activities

15. The revised BCP emphasize the need for good governance and risk management in banks, as well as fit and proper bank management and controlling persons, reflecting the increased importance of these areas. Supervisors need to be able to "look through" shareholder structures, not only to beneficial owners, but also to non-shareholders with significant influence. Changes in shareholdings need to be vetted by the supervisor who must have the authority to force unsuitable shareholders to divest. Directors and management need to be evaluated for potential conflicts of interest. The assessment criteria also emphasize that the corporate structure of the group, including outside the country of domicile of the parent company, needs to be understood and should not impede effective supervision of financial and banking groups. This also underlines the importance of effective consolidated supervision. Major acquisitions by the institution are to be subject to vetting by supervisors, and the bank can be forced to divest, if needed. A footnote has been added to indicate that small non-bank deposit taking institutions—for instance microfinance institutions—may be subject to different forms of regulation commensurate to the type and size of their transactions.

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[6] In parallel, work is ongoing in MCM to amend the Transparency standard in this sense.

C. Capital Adequacy, Risk Management, Internal Systems and Combating Criminal Abuse of the Banking System

16. To reflect the more risk-oriented approach to banking supervision, this part of the BCP includes a separate principle on risk management processes, and three new principles on liquidity risk, operational risk, and interest rate risk in the banking book. Banks are required to have comprehensive risk management policies and processes to identify, evaluate, monitor, and control or mitigate material risks. The Methodology also envisages supervisory powers to impose limits to and specific capital charges for any material risk exposures. Where supervisors permit the use of internal risk assessments for capital adequacy calculations, for instance under Basel II, these systems must be subject to rigorous supervisory qualifying standards and prior approval. Banks should also perform periodic and independent validation and stress testing. Although the earlier text included provisioning as an important part of CP 8, the new text provides a "standalone" principle to highlight the importance of adequate provisioning. More emphasis has been given to the responsibility of banks' boards and management for risk management.

17. The roles and responsibilities of bank supervisors and the financial intelligence unit in combating criminal abuse of banks have been further clarified. Close cooperation between the supervisors and authorities combating fraud and money laundering is also required, and BCBS's guidance on "know-your-customer" has been incorporated.[7]

D. On-Site Inspection, Off-Site Analysis, Reporting, and Accounting

18. External experts, including external auditors, working for the bank are required to bring material shortcomings and non-compliance with regulatory requirements to the attention of the supervisor, thus supporting the supervisory process. Disclosure requirements imposed upon banks now also cover information other than the annual financial statements. BCBS's 1998 guidance on disclosure by banks[8] has also been reflected in the revised BCP. Requirements have been added to rotate external auditors, publish banks' disclosure policies and provide the supervisor access to internal as well as external auditors' working papers.

E. Corrective and Remedial Powers

19. This CP remains largely unchanged but further clarifies that the supervisor should have a sufficiently broad and flexible range of remedial instruments. A new element is the need for supervisory involvement in decisions on resolution of problem banks. The assessment criteria do not reflect any bias toward a particular form of remedial action,

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[7] Basel, October 2001, "Customer Due Diligence for Banks," Basel, February 2003, "General Guide to Account Opening and Customer Identification."

[8] Basel, September 1998, "Enhancing Bank Transparency."

although the need for timeliness is reiterated. The BCP remains neutral on different approaches to addressing problem banks so long as the overriding goals are achieved.

F. Consolidated Supervision and Home Host Relationships

20. BCP assessments have shown that consolidated supervision, including with respect to foreign establishments of a bank, needs to be improved in many jurisdictions. The exercise of consolidated supervision has become more important with the increased complexity and global spread of financial institutions. For internationally active banks and domestic banks that are engaged in multiple financial activities, information on key risk parameters such as capital adequacy, non-performing loans and diversification of assets becomes much less meaningful without consolidated supervision. The revised BCP emphasize more explicitly that supervisors must actually exercise consolidated supervision rather than just have the authority to do so. The revised text also reinforces the need for supervisors to have a working knowledge of the structure of large banking groups, domestically as well as those abroad.

21. Considerably more detail is provided on home-host relationships, specifying what the home supervisor should expect from the host supervisor, and vice versa, building on guidance issued by the BCBS on home-host cooperation in the context of Basel II. With a caveat regarding the materiality of the information requested, the home supervisor should provide the host supervisor with timely information on the specific operations of the bank in the host country. Furthermore, information is required on the overall supervisory framework within which the banking group operates, and information on significant problems within the group that may affect operations in the host country. The host supervisor is to provide timely information to the home supervisor on non-compliance with local supervisory requirements, adverse qualitative assessments of management quality and controls of the bank's operations in the host jurisdiction, and any material remedial action the host supervisor undertakes.

G. Revision of the Methodology

22. The revised methodology stresses that the assessment must be comprehensive and sufficient in depth to allow a judgment on whether criteria are fulfilled in practice and not just in theory. Laws and regulations need to be sufficiently deep and broad in scope, and evidence is required of the real effectiveness of implementation, enforcement and compliance. To the extent that this approach had not always been fully reflected in previous assessments, and taking into account the requirements of the revised BCP, downgrades may be needed in some future updates of earlier BCP assessments, until countries meet the standards of the revised BCP.

IV. Use of the Revised BCP in Assessments

23. ICBS participants encouraged the international community of banking supervisors to work towards adapting their legislation, regulations and methods for supervision, in line with the updated standards as outlined in the revised Principles. Notwithstanding, the BCBS

decided, endorsed by the ICBS, to make the revised BCP immediately available for IFI assessments, without a transitional period. At the same time, the BCBS recognized that implementation might take time. Therefore, when future assessments will be graded on the basis of the revised BCP, which could in certain cases imply a downgrade, the BCBS encouraged the IFIs to positively reflect in the qualitative sections of their assessments countries' efforts to bring their systems up to the level of the revised BCP. Moreover, the continued validity and usefulness of the 1997 Principles means that assessment work under way at the time the revised BCP were adopted, can continue to be based on the 1997 BCP.

V. Technical Assistance

24. Within the existing resource constraints, both the Fund and the Bank are willing to assist member countries to prepare their supervisory systems to meet the requirements of the revised BCP. Countries could need assistance to build supervisory capacity, strengthen laws and regulations and improve infrastructure. Assistance to countries could take several other forms, including helping countries to perform a self-assessment, as a stand-alone exercise, or as preparation for an FSAP review. Where available, outside funding can be sought for this technical cooperation. In order to ensure that maximum benefits are derived from the technical assistance program, countries' progress in implementing reforms needs to be monitored, as a basis for effective allocation of scarce resources.

VI. Effect of Basel II on BCP Assessments

25. The revised BCP state that the capital requirements for internationally active banks should not be less than the "applicable" Basel requirement. Some form of assessment of the quality of countries' implementation of Basel II, therefore, will be needed once a country claims to have implemented Basel II. Countries that are still in the process of implementing Basel II and are not actually using it will not be assessed against Basel II.

26. The BCBS does not require the implementation of Basel II as a prerequisite for compliance with the BCP. As a result, the Methodology does not contain sufficiently detailed criteria for the assessment of Basel II compliance. The Bank and the Fund, with the assistance of a group of volunteer institutions and countries, including G10 and non-G10 countries[9] are developing additional guidance to assist assessors in forming an opinion on the quality of Basel II implementation by countries that have adopted the new capital adequacy standards**.** When countries matching this situation undergo a BCP assessment or an update, the Basel II aspects of the assessment will be included in the detailed assessment of BCP compliance This implies a substantial increase in the workload for the assessors, and sufficient time will need to be made available. The Basel II assessment criteria may also be

[9] Australia, Canada, Czech Republic, France, Germany, India, Japan, Netherlands, Spain, U.S., as well as the FSI and the BCBS Secretariat.

used on a standalone basis in a small number of pilot countries. If Basel II issues arise in the context of an Article IV mission, only a general discussion of Basel II issues would take place, as needed.

VII. Resource Implications

27. The revised BCP Methodology is a major improvement from the previous text and more reflective of current well-managed supervisory practices. As indicated in Box 2, the revised BCP Methodology contains significantly more essential criteria than the 1999 Methodology. The number of sub-criteria, or points for assessment, in the essential criteria has increased considerably, adding to the complexity and depth of the review. For example, Core Principle 25 of the 1997 text on home-host cooperation had six essential criteria, whereas in the current version Core Principle 25 has nine essential criteria, two of which contain four additional subcriteria. This expansion of criteria and the increased emphasis to be placed on assessment of actual, rather than "on paper" implementation of the standards, imply that a full assessment of compliance with the 25 CPs will be more time-consuming and labor-intensive than in the past.

28. In addition, if a country has declared that it has implemented Basel II and using it in its supervisory system, then assessment of the BCP in such a country will need to be supplemented by experts with specific knowledge of Basel II and its implementation. Experts with this profile will need to be added to such assessment missions. These experts are not readily available because they are limited in numbers and are heavily involved in Basel II implementation in their own country. The assessment of Basel II in the BCP reviews will entail requiring additional banking supervisory resources to the process.

29. A more structured arrangement will be sought with supervisory agencies to provide staff to participate in assessment missions, in particular including Basel II review, in order to facilitate planning and to support the quality of the assessments. Member countries may also be requested to provide more in-depth self assessments.

30. Bank and Fund staff intend to prepare a separate note on resource constraints versus coverage and depth trade-offs that need to be taken into consideration in the assessments of the BCP in the context of FSAPs. This note will be prepared after consultation with the Basel Committee, BCP assessors and country authorities that have undergone the revised BCP assessments. The note will address in greater detail the question how these assessments could be staffed, and estimates made of the time needed to perform the assessments. It will explore, among other things, the potential for greater use of "factual updates" or limited diagnostic reviews, structured around principles for which compliance was considered a key issue in an earlier BCP assessment (see Standards and Codes—Implementing the Fund's Medium-Term Strategy and the Recommendations of the 2005 Review of the Initiative—SM/06/219, para. 6).

Box 2. Expansion of Assessment Criteria			
	1997 BCP	**2006 BCP**	**Increase**
Core Principles	25	25	-
Essential Criteria[10]	169	200	21
Sub-Criteria	242	392	150

[10] Essential criteria are elements against which compliance rating with a Core Principle must be measured. Many essential criteria have sub-criteria or control points that must be assessed, adding to the complexity and depth of the review.

VIII. PROPOSED DECISION

The Executive Board takes note of the revisions to the Core Principles for Effective Banking Supervision (BCP) taken in October 2006 by the Basel Committee on Banking Supervision and endorses the revised BCP as the standard under which assessments will be undertaken and Reports on the Observance of Standards and Codes (ROSCs) will be prepared.