The Basel Core Principles for Effective Banking Supervision & The Basel Capital Accords

Basel Committee on Banking Supervision ("BCBS") (www.bis.org: bcbs230 – September 2012)
Basel Committee on Banking Supervision ("BCBS") (www.bis.org: bcbs189 – revised June 2011)

Agenda

- Discussion of international standard setting for banking supervision and the work of the BCBS:
  - Context of BCPs, Basel I, Basel II and Basel III
- Focus attention on the Basel Core Principles for Effective Banking Supervision ("BCPs") identified by the Financial Stability Board ("FSB") as key for international acceptance
- Emphasise the importance of effective supervision rather than the details of proposed amendments to Basel II or III:
  - A single technical issue such as the adoption of Basel II or III capital calculation is unlikely to make a substantial impact on the objective of systemic stability on its own
- Development of the Capital Accords
- Key features of Basel II and identified weaknesses
- Principal features of Basel III

Background to BCPs (1)

- The BCPs are mainly intended to help countries assess the quality of their systems and to provide input into their reform agenda and the assessment of one jurisdiction will not be directly comparable to that of another
- The BCPs are neutral with regard to different approaches to supervision so long as overriding goals are achieved
- The BCPs represent the framework within which the more detailed treatment of issues fits: the choice of methodology for the calculation of capital represented by Basel I, II or III is less significant than achieving compliance with the BCPs
- The effective implementation of the BCPs forms a firm foundation on which to build risk based assessment of banks and the more judgmental elements of Basel II/III

Background to BCPs (2)

- The first version of the BCPs was issued in 1997 and the first version of the related assessment methodology in 1999
- A full revision of both documents was published in October 2006
  - The principal change was to reinforce the need for supervisors to evidence the practical implementation of the BCPs
- A further full revision was published in September 2012 combining BCPs and the assessment methodology
- All versions of the BCPs have represented standards against which regulators can be measured. The current (2012) version covers:
  - 29 Principles & related Essential and Additional Criteria
  - Pre-Conditions for Effective Banking Supervision
  - Assessment on graded scale: Compliant (C), Largely Compliant (LC), Materially Non-Compliant (MNC) and Non-Compliant (NC)

Background to BCPs (3)

- The 2012 revision reflects the lessons of the crisis of 2007-2008 and takes account of key trends:
  - The need for greater intensity of supervision and increased resources to deal with systemically important banks
  - The importance of a system wide macro-perspective to assist in identifying, analysing and taking pre-emptive action to address systemic risk
  - An increasing focus on effective crisis management, recovery and resolution measures to reduce both the probability and impact of bank failure

Background to BCPs (4)

- The 2012 revision emphasises critical areas by:
  - Introducing a new CP to address Corporate Governance, bringing together a number of previously disparate points into a single, dedicated CP
  - Reinforcing the importance of market discipline by expanding one CP into two new CPs: one on external financial reporting/external audit and one on public disclosure/transparency
  - Greater focus on risk based supervision and the need to assess the risk profile of banks, the risks they run, the efficiency of their risk management and the risks they pose to banking and financial systems
- The 2012 revision adds 35 new essential criteria and makes 34 previously “additional” criteria into “essential” criteria

Principal concerns of BCBS

- Specify the powers that supervisors should have
- Ensure that the powers are used effectively
- Forward looking approach leading to early intervention
- Clarity of objectives for supervisors

Effective banking supervision

TIMELINESS

CAPACITY TO ACT	CAPACITY TO ASSESS	CAPACITY TO ADAPT
Processes	**Skills**	**Technical Requirements**
Licensing	Expertise *IT, Treasury, Accounting, Credit & Risk, Legal*	Capital Adequacy
Monitoring		Consolidation
Analysis		Governance
Planning cycle		Risk Management
Record-keeping	Analysis	Abuse of Financial Services
Decision making	Negotiation & Communication	Material Changes
Enforcement		
Co-operation		
Systemic overview		
Quality assurance		

Adequate Resources: Staff, IT & Communications, Premises, Storage & Archive

Foundations: Objectives, Operational Independence, Legal Framework, Legal Protection, Corporate Governance

Supervisory Objectives

- Primary objective of supervision should be the promotion of the safety and soundness of banks and the banking system
- Objective should NOT be to prevent bank failures
- Other acceptable objectives that may be added by national authorities:
  - Depositor protection
  - Financial stability
  - Consumer protection
  - Financial inclusion
- However, supervisors should NOT be given responsibility for marketing a jurisdiction

Preconditions for effective banking supervision

- Sound and sustainable macroeconomic policies
- A well established framework for financial stability policy formulation
- A well developed public infrastructure, including
  - Business laws
  - Accounting principles
  - Independent external audit
  - Efficient and independent judiciary
  - Well regulated accounting, auditing and legal professions
  - Well defined rules and supervision for other financial markets
  - A secure and efficient payments system
  - Effective credit bureaux and/or databases to assist assessment of credit risk
- A clear framework for crisis management, recovery and resolution
- Mechanisms for providing systemic protection (or public safety net), taking into account the need to avoid moral hazard in providing deposit protection.
- Effective market discipline

Summary list of BCPs

Powers, responsibilities and functions of supervisors

CP1-Responsibilities, objectives and powers
CP2-Independence, accountability, resourcing and legal protection for supervisors
CP3-Cooperation and collaboration
CP4-Permissible activities
CP5- Licensing criteria
CP6-Transfer of significant ownership
CP7-Major acquisitions
CP8-Supervisory approach
CP9-Supervisory techniques and tools
CP10-Supervisory reporting
CP11-Corrective and sanctioning powers of supervisors
CP12-Consolidated supervision
CP13-Home-host relationships

Prudential regulations and requirements for banks

CP14-Corporate governance
CP15-Risk management process
CP16-Capital adequacy
CP17-Credit risk
CP18-Problem assets, provisions and reserves
CP19-Concentration risk and large exposure limits
CP20-Transactions with related parties
CP21-Country and transfer risks
CP22-Market risk
CP23-Interest rate risk in the banking book
CP24-Liquidity risk
CP25-Operational risk
CP26-Internal control and audit
CP27-Financial reporting and external audit
CP28-Disclosure and transparency
CP29-Abuse of financial services

Four Core BCPs identified by FSB

CP3 Licensing Criteria(now CP5)
CP21 Supervisory reporting (Now CP10)
CP24 Consolidated supervision (Now CP12)
CP25 Home-host relationships (Now CP13)

Relationships with other supervisors

- Effective participation in home-host dialogue is an essential protection for regulators hosting international banks.
- The essential criteria include responsibility for regulatory colleges
- It is important to emphasise that exchanges between regulators should not be limited to attendance at colleges and a routine annual exchange of letters.
- Note that the essential criteria refer to "appropriate information" and a "timely basis"

Assessing equivalence of supervisors

- Legal powers, technical capacity, confidentiality and effectiveness
- International status
- Publications
- Laws & regulations
- BCP assessment
- Personal contact

Other key CPs (1)

CP8 Supervisory approach

Forward looking
Proportionate
Risk assessment
Early intervention

CP9 Supervisory techniques and tools

Appropriate range of techniques and tools
Proportionate use of resources taking account of risk

Other key CPs (2)

CP11 – Corrective and sanctioning powers of supervisors

- Early action to address problems
- Suitable powers

CP15 Risk management process

- The supervisor determines that banks have a comprehensive risk management
- Timely action
- Assessment of capital needs

Overall comment and issues

- Studies have not been able to prove a direct correlation between compliance with the BCPs and the financial health of individual banks
- The careful use of English to allow flexibility for a wide range of regulatory practice and banks/financial systems of varying complexity
- Interpretation of BCP assessments in the wider community
- Regulatory backgrounds of assessors and subject jurisdictions
- Appropriateness of reform agenda set out in assessment given resources available
- Verification that reform agenda has been implemented
- Time available for assessment
- Importance of self-assessment

Conclusion

- BCPs capture the issues representing a “cradle to grave” approach to the supervision of institutions
- BCPs are as the name suggests “principles” and are not prescriptive as to the detailed techniques to be used. In particular:
  - BCPs do not specify the balance of on-site and off-site work required to achieve compliance
  - BCPs do not specify which Basel Capital Accord approach should be used for calculating capital and liquidity
  - BCPs do not specify a provisioning methodology
- BCPs are based upon the concept of Risk Based Supervision and recognise that the board and management of a bank have prime responsibility for the good governance of a bank
- However, they do not prescribe, or endorse, a particular methodology

International Background to Capital Adequacy Regulation

- Basel Committee on Banking Supervision (“BCBS”)
  - Founded at end-1974, backed by G-10
  - No formal supervisory or legal authority
  - Concerned with supervision of “internationally active banks”
  - Formulates broad standards, guidelines and statements of best practice
- Basel Capital Accord 1988 – International Convergence of Capital Measurement and Capital Standards (Basel 1)
- Amendment for Market Risk 1996
- Proposals for a revised capital adequacy standard 1999
- International Convergence of Capital Measurement and Capital Standards: A Revised Framework 2004/5 (Basel II)

Key Points in respect of Basel I

- Introduced a standardised approach to capital calculation
- Universally adopted, not only for internationally active banks
- Concentration on Credit Risk
- The source of the 8% minimum capital ratio and risk weighted assets
- Defines Tier 1 and Tier 2 capital

Why replace Basel I with Basel II?

- Crude estimates of credit risks result in an extremely crude measure of risk and in danger of falling into disrepute
- Lack of recognition of effective risk mitigation techniques
- Many risks identified not covered by an explicit capital charge, e.g. operational risk
- Absence of requirement for supervisors to evaluate the actual risk profile of credit institutions to satisfy themselves that adequate capital is held having regard to that risk profile
- Absence of requirement for proper market disclosures to facilitate effective market discipline by providing reliable information for market participants to make well-founded assessments
- Basel II document is 347 pages!

Basel II – Pillar 1

MINIMUM CAPITAL REQUIREMENTS

- Provides options for calculating bank's minimum capital charges for Credit Risk, Operational Risk and Market Risk
- Options range from relatively simple methods to more complex approaches, using banks' own quantitative risk assessments
- Basel II aimed to make the risk weighting structure for credit risk more sensitive, crystallise and enhance the Market Risk/Trading Book coverage and add consideration of operational risk
- A compromise?

Basel II – Pillar 2

SUPERVISORY REVIEW PROCESS

- Conceptual framework
- Banks should self-assess own capital requirements in relation to risk profile and have a strategy for managing capital
- Supervisor evaluates bank's own assessment and reviews, monitors and ensures capital is maintained above the minimum requirement
- Formalises the process by which some regulators were already setting individual capital ratios above 8% for individual banks
- Embeds Risk Based Supervision concepts in bank supervision
- Introduces the Internal Capital Adequacy Assessment Process ("ICAAP")

Basel II – Pillar 3

MARKET DISCIPLINE

- Applies at top consolidated level of banking group
- Principal Disclosures
  - Consolidation for accounting and regulatory purposes, and certain items concerning capital in subsidiaries
  - Capital structure
  - Capital adequacy
  - Risk exposure and assessment, covering credit risk, securitisation, market risk, operational risk, equities and interest rate risk in the banking book
- Maintain dialogue with accounting standards setters

BCBS' analysis of pre-crisis weaknesses

- Too much leverage in the banking and financial system and not enough high quality capital to absorb losses;
- Excessive credit growth based on weak underwriting standards and under pricing of liquidity and credit risk;
- Insufficient liquidity buffers and overly aggressive maturity transformation, both direct and indirect (for example, through the shadow banking system);
- Inadequate risk governance and poor incentives to manage risks towards prudent long term outcomes, including through poorly designed compensation systems;
- Inadequate cushions in banks to mitigate the inherent pro-cyclicality of financial markets and its participants;
- Too much systemic risk, interconnectedness among financial players as well as common exposures to similar shocks, and inadequate oversight that should have served to mitigate the too-big-to fail problem.

Some significant concepts

- **Crises don't happen quickly**
- **Risk Management /Mitigation - Risk Avoidance**
- **Value at Risk/Advanced Models**
- **Return on Capital**
- **Management - Custodianship**
- **Perverse incentives**
- **Responsibility for credit assessment**
- **Was the SREP/ICAAP process properly implemented?**

Basel III – Key Points (1)

CAPITAL BASE

- Focuses on quality of capital and "Common Equity": share capital and retained earnings
- Phased introduction from 1 January 2013 to 1 January 2015, with some changes in regulatory deductions not implemented until January 2018

ENHANCED RISK COVERAGE

- Raising capital requirements for complex transaction to counter critical flaws found in Basel II assessments
- Some implementation by end-2011

THE LEVERAGE RATIO

- Leverage ratio of capital to total exposure
- Gradual introduction: not fully implemented until 1 January 2018

Basel III – Key Points (2)

CAPITAL CONSERVATION

- Banks must maintain a 2.5% buffer of capital above the regulatory minimum 8%,
- To be phased in between 1 January 2016 and year-end 2018

EXCESS CREDIT GROWTH

- National authorities will monitor credit growth (and other systemic indicators) to identify "excessive credit growth"
- Introduces a "systemic" capital buffer of 0% to 2.5%

GLOBAL LIQUIDITY STANDARDS

- **Liquidity Coverage Ratio** – Stock of high quality unencumbered liquid assets greater than or equal to net cash outflows under an acute short-term stress scenario (next 30 calendar days)
- To be phased in from 1 January 2015 to 1 January 2018
- **Net Stable Funding Ratio** – Available amount of stable sources of funding must be equal to or greater than required stable funding based on the liquidity profiles of assets as well as potential for contingent liquidity needs arising from off-balance sheet commitments, over a one-year horizon
- Aim to introduce from 1 January 2018

Conclusions on Basel III

- Highly technical and detailed
- Will Basel III work?
  - There is little wholly new in the concepts
  - Levels of capital that may be required
  - Still parameters to be quantified
  - Plenty of room for argument by individual institutions
- May have limited relevance in many jurisdictions
- Pillars 2 & 3 remain vital to effective implementation