SM/02/310

October 4, 2002

To: Members of the Executive Board

From: The Secretary

Subject: **Implementation of the Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives**

Attached for the information of the Executive Directors is a paper on the implementation of the Basel core principles for effective banking supervision, experience, influences, and perspectives prepared jointly by the Fund and the Bank. The staff proposes the publication of this paper on the Fund's external website.

Questions may be referred to Mr. van der Vossen (ext. 38556) in MAE.

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INTERNATIONAL MONETARY FUND AND WORLD BANK

Implementation of the Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives

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September 23, 2002

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[1] The Secretariat of the Basel Committee on Banking Supervision has been provided the opportunity to comment on earlier drafts of this paper, and its comments have been duly taken into consideration.

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LIST OF ABBREVIATIONS

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
Basel II	Proposal for a new Capital Accord
BCBS	Basel Committee on Banking Supervision
BCP	Core Principles for Effective Banking Supervision
CP	Core Principle
CPSS	Committee on Payment and Settlement Systems
CPSIPS	Core Principles for Systemically Important Payment Systems
FATF	Financial Action Task Force
FSF	Financial Stability Forum
FSI	Financial Stability Institute
FSLC	Joint Bank-Fund Financial Sector Liaison Committee
FIRST	Financial Sector Reform and Strengthening Initiative
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
IAAB	International Auditing and Assurance Standard Board
IADI	International Association of Deposit Insurers
IAIS	International Association of Insurance Supervisors
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IRB	Internal Ratings-Based
IT	Information Technology
LCFI	Large and Complex Financial Institution
LEG	IMF Legal Department
MAE	Monetary and Exchange Affairs Department
MFP	Monetary and Financial Policy
OECD	Organization for Economic Cooperation and Development
OFC	Offshore Financial Center
PDR	Policy Development and Review Department
ROSC	Reports on the Observance of Standards and Codes
SECO	State Secretariat for Economic Affairs of Switzerland
TA	Technical Assistance
VaR	Value at Risk

EXECUTIVE SUMMARY

1. Since the introduction of the Core Principles for Effective Banking Supervision (BCP) in September 1997 by the Basel Committee on Banking Supervision (BCBS), the Fund and the Bank have conducted **BCP compliance assessments of 60 countries** as of end-2001, using a Methodology developed by BCBS, consisting of an agreed-upon list of assessment criteria. The assessment program has been implemented with the assistance of many cooperating banking supervision authorities and central banks. An earlier evaluation of compliance experience, presented to the Fund Board in May 2000, reviewed the first 26 assessments, not all of which had been performed on the basis of the Methodology. Currently, it is the policy of the Fund and the Bank to conduct BCP assessments virtually exclusively in the context of an FSAP. This provides a better framework for a sector wide and integrated view on vulnerabilities and compliance with standards and preconditions.

2. This paper reviews the Fund/Bank experience in conducting BCP assessments to identify the main issues with respect to the effectiveness of banking supervision, while taking into account the pending revision of the Capital Accord. Moreover, since the introduction of the BCP in 1997, supervisors worldwide are being increasingly challenged by new developments in the financial markets and the banking supervisory framework. This paper attempts to distill the more important implications of all these issues for the standard-setting body, assessed countries, and the assessing institutions.

3. Going forward, three key reform themes emerge from this review:

- **In view of their importance for the effectiveness of the supervisory framework, the preconditions[2] for effective banking supervision need to be assessed more explicitly in the context of the FSAP process and the BCP assessment.** The assessment of the precondition of "stable macroeconomic policies" would remain a part of the Article IV process. Preconditions related to public infrastructure, and market discipline, in view of their implications for other parts of the financial sector, may need to be reviewed in the broader context of an FSAP. However, remaining preconditions, i.e. adequate procedures to address problem banks and the effectiveness of safety nets, could be taken out of the preconditions and made part of the BCP. The detailed assessment and the associated ROSCs should in any case contain a substantial, discrete section on compliance with all preconditions.

- **Independence of supervisory authorities needs to be strengthened and guidelines governing aspects of this are needed.** Without independence, effective banking supervision is not possible; protection against political influence and lawsuits *(albeit while still being held accountable for responsibly discharging their assigned duties)*, as well as budgetary and operational independence, need to be explicitly secured and, guidance on good governance for supervisory agencies is advisable.

[2] The preconditions consist of stable macroeconomic policies, a well-developed legal and judicial infrastructure, effective market discipline, procedures for the effective resolution of banks, and effective safety nets.

- **Guidance on good practices in loan classification and provisioning is urgently needed.** Without more accurate asset valuation and provisioning, profitability, capital and capital adequacy figures are seriously flawed. At a minimum, a checklist of the critical ingredients of an effective credit-policy regulation—covering loan evaluation, income recognition, collateral and its valuation, establishment of loan loss reserves and credit risk disclosure—needs to be developed.[3]

4. At the national level, core principles compliance is particularly weak in a number of key areas. Urgent action is needed to address these weaknesses, as listed below:

- **Credit policies and connected lending guidelines** need strengthening, as poor lending practices remain one of the most important threats to banking stability.

- **Consolidation of accounts and supervision on a consolidated basis,**[4] especially for effective supervision of large and complex financial institutions (LCFIs), require continued emphasis, particularly in the area of legal framework and supervisory capacity.

- Banks need to implement rules on **anti-money laundering and combating the financing of terrorism** (AML/CFT) far more rapidly.

- **Prompt and effective remedial measures need to be implemented**. To this end, it is especially important that the supervisory authority have an adequate degree of independence.

- **Many countries need to strengthen their systems for managing country risk, market risk, including foreign exchange risk, liquidity risk, and interest rate risk in the banking book. These risks** tend to be underestimated in many countries, even in countries where these risks may not seem to be a serious supervisory threat.

5. Additional guidelines are advisable in several other areas, especially regarding the different aspects of the supervision of large complex financial institutions including cross border cooperation, the supervisory regime for state banks, corporate governance for banks, and the management of operational risk.

6. There is also scope for strengthening of the assessment process itself:

- **More transparency and guidance from the Bank and the Fund for the assessors and the assessed countries is needed** with regard to the assessment process, methodology and technical assistance follow-up. Fund and Bank staff have already taken actions to

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[3] See for instance the "World Bank-Core Principles Liaison Group Survey Paper on Loan Classification and Provisioning", January 2002.

[4] Supervision on a consolidated basis indicates supervision of the total group of companies (and the risk implications therein) of which the bank is a part.

address these concerns, but additional efforts are needed. In this regard, a balance will need to be struck between the legitimate **wish to refine the assessment process,** including pre-FSAP work, more attention to consistent application and assessment of procedures and criteria,[5] review of actual implementation, and pre-departure discussion with the authorities, and the need to keep a **limit on the resources devoted to the standard assessment process in FSAPs**.

- **Consistent with the BCP methodology, actual implementation of the BCP needs to receive more emphasis** in the assessments. Partly due to time constraints, assessors may focus too heavily on technical and legal compliance with the BCP in order to meet completion deadlines, with limited time dedicated to more thorough assessment of actual implementation. Additional guidance to assessors on assessing actual implementation will be useful, but ultimately robust assessment requires that assessors possess the requisite experience and skills and also devote the additional time, where needed, to focus on actual implementation.

- More attention needs to be paid to **linkages between sector assessments and the macro-economic situation,** through closer liaison among sector assessors and with the macro-specialists on the FSAP team. This will also provide scope for an appropriate assessment of compliance with the preconditions.

7. **The detailed findings of this review will be communicated to the BCBS** by Bank and Fund staff, including suggestions for future revision of the BCP and the assessment Methodology, as well as to the Fund-Bank Financial Sector Liaison Committee (FSLC) to help to strengthen the assessment of banking systems under the FSAP.

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[5] Consistency of assessments across countries has been a concern of a number of countries, although the assessments are not intended for cross-country comparison, but as a benchmark for further upgrading of the supervisory systems of individual countries.

I. Introduction

8. Based on the review of BCP assessments of 60 countries, the purpose of this paper is to review which experiences and influences should be taken into account to ensure, looking forward, that the Fund/Bank BCP assessment program remains effective and relevant to evolving needs, while also addressing the appropriate issues and conducting assessments in the most effective way. How can the Fund/Bank BCP assessment program continue to provide an optimal contribution toward international financial sector stability?

9. Since 1997, financial sector crises in a number of countries, for instance Argentina, Ecuador, Indonesia, Korea, Russia, Thailand, and Turkey, have highlighted linkages between financial sector crises and weak macroeconomic policies, while also showing the adverse effects of poor lending practices, weak corporate governance, inadequate loan provisioning, accounting and auditing practices, and insufficient supervisory independence. In many cases, the preconditions for effective banking supervision, which include sound and sustainable macroeconomic policies, a well-developed public infrastructure, effective market discipline, procedures for effective bank resolution, and systemic protection or a safety net, had not been met sufficiently.

10. Since the introduction of the BCP, [6] these principles have come to be regarded as the global standard for the quality of countries' banking supervision systems. The Fund and the Bank have played an important role in the formulation, dissemination, and monitoring of compliance of the BCP. Both institutions have engaged in an extensive exercise to review countries' compliance with this standard. Experience from these assessments has shown considerable differences in compliance with the BCP across countries and groups of countries, and has highlighted weaknesses in countries' supervisory systems and potential risks to financial stability. In May 2000, the Fund Board discussed an initial overview of the first 26 BCP assessments.

11. The experience of the Fund and the Bank as well as of the assessed countries should also be taken into account when reviewing the continued effectiveness of the program. In this context, the BCP Methodology[7], as a key tool for the assessment of compliance with the standard will also require review as certain principles may need reinforcement or more elaboration in the Methodology. Moreover, some principles are so interrelated that their individual assessment of compliance is less meaningful. In the future, a method should be developed to take into account the greater emphasis of the new Basel Capital Accord (Basel II) on national discretion in introducing and implementing supervisory standards.

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[6] See Box 1 on the Core Principles for an Effective Banking Supervision.

[7] The BCBS issued a "Core Principles Methodology" that, among other things, clarified the interpretation of each Core Principle by specifying detailed criteria for assessing compliance.

Box 1. Core Principles for Effective Banking Supervision

The Basel Core Principles comprise 25 basic principles that need to be in place for a supervisory system to be effective. The Principles relate to:

Objectives, autonomy, powers and resources

CP 1 is divided into six parts:

CP 1.1 deals with the definition of responsibilities and objectives for the supervisory agency.
CP 1.2 deals with, skills, resources and independence of the supervisory agency.
CP 1.3 deals with the legal framework.
CP 1.4 deals with enforcement powers
CP 1.5 requires adequate legal protection for supervisors.
CP 1.6 deals with information sharing.

Licensing and structure

CP 2 deals with permissible activities of banks.
CP 3 deals with licensing criteria and the licensing process.
CP 4 requires supervisors to review, and have the power to reject, all significant transfers of ownership in banks.
CP 5 requires supervisors to review major acquisitions and investments by banks.

Prudential regulations and requirements

CP 6 deals with minimum capital adequacy requirements. For internationally active banks, these must not be less stringent than those in the Basel Capital Accord.
CP 7 deals with the granting and managing of loans and the making of investments.
CP 8 sets out requirements for evaluating asset quality, and the adequacy of loan loss provisions and reserves.
CP 9 sets forth rules for identifying and limiting concentrations of exposures to single borrowers, or to groups of related borrowers.
CP 10 sets out rules for lending to connected or related parties.
CP 11 requires banks to have policies for identifying and managing country and transfer risks.
CP 12 requires banks to have systems to measure, monitor and control market risks.
CP 13 requires banks to have systems to measure, monitor and control all other material risks.
CP 14 calls for banks to have adequate internal control systems.
CP 15 sets out rules for the prevention of fraud and money laundering.

Methods of ongoing supervision

CP 16 defines the overall framework for on-site and off-site supervision.
CP 17 requires supervisors to have regular contacts with bank management and staff, and to fully understand banks' operations.
CP 18 sets out the requirements for off-site supervision.
CP 19 requires supervisors to conduct on-site examinations, or to use external auditors for validation of supervisory information.
CP 20 requires the conduct of consolidated supervision.

Information requirements

CP 21 requires banks to maintain adequate records reflecting the true condition of the bank, and to publish audited financial statements.

Remedial measures and exit

CP 22 requires the supervisor to have, and promptly apply, adequate remedial measures for banks when they do not meet prudential requirements, or are otherwise threatened.

Cross-border banking

CP 23 requires supervisors to apply global consolidated supervision over internationally active banks.
CP 24 requires supervisors to establish contact and information exchange with other supervisors involved in international operations, such as host country authorities.
CP 25 requires that local operations of foreign banks are conducted to standards similar to those required of local banks, and that the supervisor has the power to share information with the home country supervisory authority.

12. The new Basel Capital Accord (Basel II) will also have an impact on regulatory systems across countries and on the BCP. Monitoring of the effectiveness of banks' risk management practices will take a more prominent place under Basel II, as well as the effectiveness of the supervisory review process, disclosure and market discipline.

13. In the field of prudential supervision, increased attention is being given to the emergence of large and complex, internationally active financial institutions, the need for better cooperation, coordination and exchange of information between financial sector supervisors domestically and across borders, and renewed attention for accounting and auditing standards. Also, supervisors have been asked to work more closely with banks in promoting compliance with AML/CFT standards. Furthermore, other international standards setters such as the IAIS, IOSCO, FATF, and the Fund, through its MFP Transparency Code, have issued standards and codes which need to dovetail with the BCP in order to avoid overlaps, gaps, and inconsistencies in the overall assessment process.

14. The remainder of this paper is organized as follows: Chapter II analyzes the findings of the assessments undertaken through the end of 2001. Chapter III reviews experiences with the assessment process, obtained through feedback from assessors and country authorities, as well as those based on the own experience of Fund and Bank staff that participated in assessments, and highlights some areas for improvement. Chapter IV discusses recent prudential developments, including the new Basel capital proposals, and their impact on the content of the BCP and the assessment process. Chapter V discusses implications of these developments for future work of the standard-setting body, the assessed countries and the assessors. Chapter VI attempts to draw preliminary conclusions.

II. Experience with BCP Observance

A. Introduction

15. In its May 2000 discussion, IMF Executive Directors[8] noted serious weaknesses in banking supervision in many countries, especially in the areas of risk management, corrective actions, and consolidated supervision. Additional sources of weaknesses arose from deficiencies in many of the preconditions for effective banking supervision, loan valuation procedures, accounting systems, legal processes, and market discipline. The Board welcomed the positive effect of the Methodology on the quality of the assessments, and noted the value of self-assessments. Without neglecting other areas, Directors considered that TA should focus on the main weaknesses found in the review, and resources for this purpose should continue to be carefully reviewed and increased as needed. Directors welcomed the Fund's increasingly active collaboration and dialogue with the Basel Committee and encouraged the Fund staff to contribute to the efforts of the Basel Committee to further improve the Core Principles and their implementation (see Box 2).

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[8] "Experience with Basel Core Principles Assessments," April 2000, SM/00/77.

Box 2. Follow-Up After 2000 Review

The number of banking supervisory agencies that have been assessed has expanded significantly. Countries are now encouraged to request BCP assessments within an FSAP/OFC (Offshore Financial Center) assessment, because the comprehensive scope of the FSAP/OFC programs has proven to be a meaningful context for BCP assessments. A self-assessment is generally required prior to the mission but, because it is a time consuming and resource intensive process, country authorities are not always able to submit it. Assessors identify and discuss with the authorities the weaknesses and specific measures aimed at enhancing observance. Upon request, technical assistance is provided to address the identified weaknesses.

In addition, Fund and Bank staffs have actively participated in the work undertaken by the Basel Committee, especially by its Core Principle Liaison Group (CPLG), where both institutions are represented. Fund and Bank staffs periodically submit for discussion reviews of the findings from the assessments and contribute to the documents issued by the CPLG for discussion, with the aim to identify and address issues relevant to the BCP assessments and ultimately to financial stability. In this context, the Fund and Bank staffs took an active role in the drafting of the document " Conducting a Supervisory Self-Assessment. Practical Application."

16. This section analyzes the main results of the assessments undertaken as of December 2001. For several reasons, it is difficult to draw conclusions about countries' progress in implementing the BCP since May 2000, mainly because group composition has changed.[9]

17. The aggregate results of the assessments are largely indicative of the stage of development or transition of the countries. Reaching full, or a large degree of compliance is still considered a long term goal for many countries, which will require continued work on their part. Many of the areas that were signaled as weak in the 2000 review, are still relatively poorly complied with, for instance the principles on country risk and market risk, money laundering and consolidated supervision. Also non-compliance or weak compliance with supervisory independence is still relatively high. The absolute levels of weak or non-compliance have declined. In 2000, for instance, nearly 70 percent of assessed countries were non-compliant or materially non-compliant with the core principle on market risk. Now, that percentage is close to 50 percent. Weak or non-compliance on money laundering dropped from 70 percent to 50 percent.

18. Partially this "softening" of the outcomes may be explained by the relatively much larger percentage of industrialized countries that have been assessed, from one in 26, to nine in 60. Without a reassessment of countries[10], no information is available on whether countries that have been assessed have improved their systems after their initial assessment. What is more relevant, however, is the relatively large number of countries that still show weaknesses on essential

[9] The breakdown into grouping has changed, as assessments are voluntary. Also, only assessments based on the Methodology were used, which was not the case with the first review.

[10] Only three countries have been reassessed since their initial review.

points such as independence of the supervisor and consolidated supervision. It would be misleading to conclude that compliance has improved across the board over the past two years.

19. As of December 2001, 60 assessments had been performed, including 15 transitional countries, 36 developing countries, and the remainder advanced economies[11]. Assessments have taken place: (i) on a "stand alone" basis, (ii) as part of the Financial Sector Assessment Program, or (iii) as part of the OFC (Offshore Financial Center) program.[12]

Table 1: BCP Assessments Performed

Year[13]	Total	FSAP	OFC	Others
1999 and before	12	3	-	9
2000	24	16	-	8
2001	24	19	4	1
Total	60	38	4	18

B. Main Findings[14]

20. Table 2 summarizes compliance with individual BCPs. The assessments[15] for each BCP were aggregated across all 60 countries.[16]

[11] The classification is based on that applied in Fund's World Economic Outlook.

[12] See Table 1 on BCP assessments performed.

[13] Year in which last assessment mission in the country was completed.

[14] The assessments, on which this section is based, cannot guarantee full consistency between country gradings because of the different experiences and views of the individual assessors.

[15] The Methodology establishes five assessment categories: (i) compliant, implying full observance or only insignificant shortcomings with regard to the "essential" criteria; (ii) largely compliant, where only minor shortcomings are observed, which do not raise doubts about the authority's ability to achieve the objectives of the principle; (iii) materially non-compliant, where the shortcomings raise doubts about the ability to achieve observance, but substantive progress has been made in rectifying the deficiencies; (iv) non-compliant, when, in the judgment of the assessors, no substantive progress toward observance has been achieved; and (v) not applicable.

[16] For an aggregation by groups of countries, see Figures 1–4 in Appendix I.

Table 2. Core Principles Compliance
(In percentages of 60 countries assessed)[1]

	Compliant	Largely compliant	Materially Non-compliant	Non-Compliant	Not Applicable
1. Framework for supervisory authority					
1.1. Objectives	63	24	13	0	0
1.2. Independence	30	30	37	3	0
1.3. Legal framework	63	27	7	3	0
1.4. Enforcement powers	52	28	18	2	0
1.5. Legal protection	46	13	17	22	2
1.6. Information sharing	40	28	25	7	0
2. Permissible activities	63	30	5	2	0
3. Licensing criteria	38	47	12	3	0
4. Ownership	52	21	17	10	0
5. Investment criteria	28	45	22	5	0
6. Capital adequacy	28	37	33	2	0
7. Credit policies	37	23	38	2	0
8. Loan evaluation	25	46	27	2	0
9. Large exposures	32	43	22	3	0
10. Connected lending	28	30	32	10	0
11. Country risk	23	10	10	35	22
12. Market risks	23	29	35	13	0
13. Other risks	17	38	27	18	0
14. Internal control	32	36	22	10	0
15. Money laundering	28	22	20	30	0
16.On-site and off-site supervision	42	38	18	2	0
17. Bank management	48	39	10	3	0
18. Off-site supervision	35	35	28	2	0
19. Validation of information	47	33	20	0	0
20. Consolidated supervision	23	12	30	23	12
21. Accounting	35	42	20	3	0
22. Remedial measures	23	35	40	2	0
23. Global consolidation	25	17	18	12	28
24. Host country supervision	32	22	18	8	20
25. Supervision of foreign establishments	43	27	23	5	2

1/ Source: BCP, FSAP reports, OFC reports

21. Table 3 shows that 32 countries are compliant with 10 or fewer BCPs. Many of these countries are still in the process of building their supervisory systems to meet BCP standards or reforming them. Only five countries were assessed as fully compliant with 25 or more of the BCPs.[17]

[17] The shortcomings or weaknesses in the BCPs reviewed in the subsequent paragraphs correspond to those most frequently mentioned by the assessors as recommended areas for priority action.

Table 3. Country Compliance
(In number of BCPs)[1]

Number of Principles with which countries comply	number of countries	Advanced economies	Transitional countries	Developing countries
26-30[2/]	5	4	1	-
21-25	5	2	-	3
16-20	6	1	4	1
11-15	12	1	2	9
6-10	11	1	3	7
0-5	21	-	5	16
TOTAL	60	9	15	36

1/ Source: BCP, FSAP reports, OFC reports.
2/ Although the BCP and the Methodology state that the Basic Core Principles comprise twenty-five Principles and requires evaluation of compliance with each Principle, the Methodology divides Principle 1 into six component parts and considers that "a more detailed assessment of Principle 1 is required, given its importance for assessing the overall potential effectiveness of the banking supervision function." Currently, assessments are performed individually for each of the six sub-principles in BCP 1 and an overall rating for BCP1 is not always provided (only in 13 assessments out of the 60). For the initial 26 assessments discussed in the May 2000 paper a proportionately larger number of assessments had provided an overall assessment of BCP 1. Therefore, in this paper, the six sub principles included in BCP1 have been listed separately. The 24 principles plus the six sub-principles of BCP 1 together account for 30 principles.

22. One of the key objectives of the BCP is to contribute to international financial stability. It is clear that instability in systemically significant countries can spill over to other countries, either on a regional level or globally. Of the population of countries that have been assessed so far, only a few countries can be considered to be of systemic importance on a regional or global level: Canada, France, India, Indonesia, and South Africa. Only recently have more systemically important countries agreed to an FSAP / BCP assessment. Currently, there is no scope for analysis of the direct linkage between the level of BCP compliance and financial sector stability, as the latter depends on many other variables as well.

23. Developing countries generally show lower levels of compliance than advanced economies or transitional countries. Many of the transitional countries assessed have intermediate levels of compliance. Weaknesses in compliance in developing and transitional countries are more widely spread across the BCPs and are more interrelated.

24. Advanced economies generally possess more robust internal frameworks as defined by the preconditions. Some of the main shortcomings found include a lack of sufficiently explicit powers to require changes in the composition of bank boards and senior management or to reverse the appointment of a manager once the person has been hired (i.e. the authority to effectively address bank governance weaknesses). In some countries, supervisors lack powers to require a bank to strengthen its lending practices and levels of provisions and reserves.

25. Developing countries generally are characterized by less favorable preconditions, including unstable macroeconomic conditions, inadequacies of the laws and judicial systems,

weak credit culture and accounting systems, low disclosure and incipient or nonexistent safety nets. The overriding weakness in a number of countries is the lack of bank and/or supervisory independence from political influence. This influence is most apparent with regard to the management of public banks and the handling of weak banks. Budget constraints limit staff numbers and training. The effectiveness of supervision also suffers from the lack or inadequate exercise of consolidated supervision. Weaknesses are also found in other important areas such as capital adequacy and risk management.

26. Weakness in compliance with preconditions is difficult and time-consuming to address, and often relates to areas outside the jurisdiction of the supervisory authorities. Improvements in the accounting, legal and judicial systems are medium to long-term issues, which cannot be remedied easily. Supervisory independence may require changes in the Banking and Central Bank Laws as well as constitutional law. These issues may need to be addressed in a longer term, well-coordinated, technical assistance program. Specifically, research supports that supervisory independence plays a key role in achieving financial stability.[18]

27. Countries in transition generally have made more progress in establishing macroeconomic stability and implementing institutional and structural reforms. However, banking culture and corporate governance have not yet been fully developed and legal and judicial systems still suffer deficiencies. Fuelled by their will to become members of the European Union, many Central and Eastern European countries are in the process of implementing new prudential regulations. The review of compliance with BCPs has shown that supervisory agencies have invested in human resources, but there still remains a need for more experienced supervisors and more training in areas such as credit risk analysis, market risk and consolidated supervision.

C. Specific Areas of Concern

28. The following paragraphs review the preconditions and principles of which compliance has tended to be weakest, in terms of the percentage of countries receiving a compliance rating of "materially non-compliant" or "non-compliant" for that particular BCP.[19] Within the BCBS, and within the group of assessors, discussions have taken place on the relative importance of individual core principles, but it was concluded that the relative importance is very difficult to measure, and differs from country to country. Also, any type of weighting of the core principles would be extremely difficult to achieve. In practice, assessors will group interrelated core principles in their analysis, for instance on the key issues of credit risk management, connected lending, and effective on-site supervision, but also here these groupings may differ from country

[18] See IMF Working Paper WP/02/46, "Regulatory and Supervisory Independence and Financial Stability", by Marc Quintyn and Michael Taylor.

[19] All BCPs where the sum of "materially non-compliant" and "non-compliant" ratings is more than 30 percent are reviewed, paying more attention to those where the sum is more than 40 percent.

to country. Assessors should take these interlinkages into account and report on them in the assessment.

Preconditions for effective banking supervision:[20]

29. Overall, the findings of this survey suggest that compliance with the BCP is positively correlated to compliance with the preconditions and the stage of development of the financial sector.

30. The preconditions are not formally a part of the BCP, as they are largely outside the jurisdiction of the supervisory authorities. Thus, the BCP Methodology does not develop specific criteria for the assessment of compliance with the preconditions. However, the Introduction to the Methodology does mention the preconditions, i.e. sound and stable macroeconomic policies, good public infrastructure, efficient bank resolution procedures, and appropriate safety nets. These elements are not explicitly covered in the assessments, but a more structured approach to their evaluation could improve the analysis of the BCPs. It could furthermore enhance the discussion within an FSAP of linkages between the macro economy, the condition of the banking sector and the effectiveness of supervision. This is in part the argument for including the BCP assessments into the FSAP, in order to better illustrate the linkages between the soundness of the banking system and the macro economy.

Box 3. Preconditions for Effective Banking Supervision and Criteria of the Basel Core Principles Methodology

Basel Core Principles Section II

"Banking supervision is only part of wider arrangements that are needed to promote stability in financial markets. These arrangements include: (i) sound and sustainable macroeconomic policies; (ii) a well-developed public infrastructure; (iii) effective market discipline; (iv) procedures for the efficient resolution of problems in banks; and (v) mechanisms for providing an appropriate level of systemic protection (or public safety net)."

Introduction to the Basel Core Principles Methodology

"The Basel Committee recognizes that effective banking supervision requires a set of preconditions to be in place. While these preconditions are largely beyond the control of the supervisory authority, weaknesses or shortcomings in these areas may significantly impair the ability of the supervisory authority to implement effectively the Basel Core Principles. Hence, the assessors should form a view as to whether these preconditions are in place as well as the potential problems any shortcomings might entail and whether best efforts are being made to correct those shortcomings."

[20] See Box 3. Some of the Preconditions are also relevant for the assessment of observance of other standards, for instance on securities and insurance supervision.

31. The most frequent weaknesses found in the set of preconditions are:

- Unstable macroeconomic conditions: many supervisors have not developed sufficient analytical frameworks to take into account the implications of macroeconomic conditions in their banking systems, in many cases due to the lack of accurate data and insufficient IT resources.

- Obsolete bankruptcy laws, long judicial delays in loan collection and procedures for collateral foreclosure (due to overloaded courts or courts subject to undue influence) hamper the development of a proper credit culture. Weak accounting standards, lack of reliable and meaningful information in financial reports, long lags in the publication of the annual accounts and the absence of a high quality audit profession are also frequently found.

- Inefficient resolution of bank problems: Supervisors lack the ability or the resolve to step in early in the process and see to the prompt and orderly resolution of problem banks. Furthermore, there is, in some countries, a widespread presumption that the authorities would not allow any bank to fail. In many countries, deposit insurance arrangements are not in place or are in the process of being set up.

32. Another issue that is not addressed explicitly in the preconditions or the BCPs (although closely related with BCP 2) is the treatment of non-bank financial entities and other deposit-taking companies, in light of the vulnerabilities they may represent for the banking system. The scope of banking supervision is not uniform in countries around the world. For instance, different approaches are applied to the mutual credit sector across countries. In several countries, the numerous credit unions are only partially covered or not covered at all by the Core Principles, while in others they are subject to full supervision (usually less intense than for "banks"). Another case involves the supervisory approach to the "informal sector" made up of micro-finance institutions or individuals, which in some countries, has become a significant sector.

BCP 1 on the framework for supervisory authority.

33. Almost half of the assessed countries are compliant with most of the elements of BCP 1, and have the framework for effective banking supervision broadly in place. In light of the relevance for effective supervision, it should be noted that of the six components of BCP 1, the independence of the supervisory authority (BCP1.2) shows the lowest level of compliance. Table 2 indicates that in 40 percent of assessed countries supervisory independence is still considered a major problem. On this point, supervisory agencies need a firmer legal and institutional basis, as well as adequate financial and human resources that allow them to take prompt remedial action when needed, also against weak state-owned banks. Lack of trained supervisors is seen as a major weakness since it impacts the observance of many other principles.

34. Weak observance is also found in another two components of BCP1. Legal protection for supervisors (covered by BCP 15; almost 40 percent non-compliant or materially non-compliant) varies widely across countries. Efficient action against problem banks is often reversed by a weak court system. Furthermore, in only about a third of countries, formal arrangements have been established for sharing information with domestic supervisors of other financial sectors and

with banking supervisory agencies abroad (BCPs1.6, 24 and 25.). This is especially relevant in light of the fact that foreign banks have an increasingly significant presence in many countries. Even when the arrangements are in place, the exchange of information is infrequent and not sufficiently informative. The existence of bank secrecy provisions many times prevents information sharing between supervisors.

BCPs 7 and 10 on credit policies and connected lending.

35. About 40 percent of countries show weak compliance with these principles. Losses from credit risk remain the largest threat to sound banking systems. They are often the consequence of "name lending," connected and government-directed lending, lax management controls and poor credit risk management techniques. Banks and supervisors often rely on lagging indicators of loan performance. Loans are frequently granted based exclusively on the existence of collateral, insufficiently taking into account actual cash flow needed to service the loans. Bank supervisors need to insist more on banks making loans based on the lender's capacity to repay the loan and on improvement of lending policies and procedures. Where collateral is taken, it must be conservatively valued to reflect current fair value. Especially in the absence of effective consolidated supervision, identification of connected and related borrowers can be extremely difficult. Often, complex governance, ownership and corporate group structures are used to hide connected exposures from banks and supervisors. Furthermore, regulations in regard to connected lending differ widely among countries, and are often not implemented sufficiently rigorously.

BCP 8 on loan evaluation.[21]

36. About 30 percent of countries show weak compliance with this related principle. In many countries, the guidelines for loan loss classification and provisioning show serious deficiencies: lenient classification of problem loans, excessively generous treatment of collateral and valuation of foreclosed assets, weak treatment of restructured operations and unfavourable tax treatment of provisions. In many countries, even when formal loan classification and provisioning regulations are adequate, the actual verification by the supervisor of banks' reports on asset quality may be weak. Frequently, the supervisors rely excessively on banks' internal and external audit systems to verify the accuracy and completeness of such reporting. Furthermore, underlying asset valuation, particularly in distressed bank situations, has been found to be repeatedly suspect. Inaccurate asset values, inadequate loan provisioning, and improper income recognition on non-performing assets overstate income and therefore misstate capital positions and adequacy, all of which are used by the market place as key bank performance indicators. Even though many supervisory agencies have improved their guidelines and capacity to evaluate asset quality, many still require further development and enforcement capacity. Many supervisory agencies need to adopt a more effective on and offsite processes to verify banks' asset classification, valuation, and provisioning policies and practices and the accuracy therein. In particular, this requires more active onsite evaluation of loan quality and reporting verification.

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[21] Non-compliance with CP 8 on loan evaluation is a major weakness of supervisory systems. Although the percentage of weak compliance is below 40 percent, the importance of the principle recommends paying close attention to it.

BCP 11, 12, and 13 on country risk, market risk and other risks.

37. Nearly half of the countries assessed show weak compliance with these principles. Monitoring of these risks is at an early stage in many countries, as risk levels may be minimal, with the exception of liquidity risk. Currently, country risk is often not considered an issue and is frequently not addressed. Many supervisors have not developed their own techniques for the supervision of banks' liquidity and interest rate risk. In many transitional and developing countries supervisors often lack expertise in these areas. However, looking forward, and depending on the state of development of the economy and the markets, supervisory authorities may need to develop mechanisms to address these risks.

BCP 15 on money laundering.

38. As many as 50 percent of countries show weak compliance with this principle. Most member countries of the Financial Action Task Force (FATF) and many outside the FATF are in the process of issuing or have already issued laws and regulations complying with AML/CFT standards set up by the FATF. However, "know-your-customer" requirements are not always sufficiently detailed and tested in practice. The involvement of bank supervisors under BCP 15 is typically limited to monitoring whether banks have put appropriate systems in place for the implementation of know your customer rules, reporting of unusual transactions, staff awareness training, and appropriately disseminated policy statements against money laundering. The supervisors are usually also under an obligation to report any signs of money laundering in supervised institutions to the law enforcement authorities.

BCP 20 on consolidated supervision.

39. More than half of the countries assessed show weak compliance with this principle and 30 percent with BCP 23 on global consolidation. Many countries are in the early stages of implementing the necessary legal scope to conduct consolidated supervision and to require consolidated accounting and regulatory reporting. Certainly in transition countries, internationally accepted accounting standards have only recently been introduced and are in the early stages of being implemented. Also other weaknesses, such as poor administration of company formation and shareholder registration, make supervision on a consolidated basis difficult to implement. Without accurately consolidated accounts and adequate supervisory capacity, supervisors will not be able to form a complete view of a bank's risk profile and governance structure. Lack of consolidated accounts and prudential reports impedes the understanding of true bank solvency and of aggregated risk exposures of the subject conglomerate as banks can transfer risk to unconsolidated subsidiaries. Also, compliance with other prudential standards such as asset diversification, large exposures, and connected parties becomes difficult to monitor.

40. Especially in light of the emergence of large and complex financial institutions that operate across borders, countries need to urgently develop their consolidated oversight capabilities. Several agencies working on the basis of different legal and regulatory regimes in different jurisdictions may be involved in assessing the risks incurred by a cross-sector financial services group. Data collection, information exchange across sectors and internationally, as well as analysis tend to be underdeveloped. Especially relatively young supervisory agencies which

are still building up their supervisory capacity, may be at a serious disadvantage when confronted with complex financial groups.

BCP 22 on remedial measures.

41. Slightly more than 40 percent of countries show weak compliance with this principle. In this area, supervisory agencies often lack enough independence, have weak legal protection for supervisory staff and weak judicial back-up of supervisory actions. In some emerging countries, authorities are unable to follow up on conclusions reached during the supervisory process because the courts have suspended their decisions.These circumstances undermine effective remedial action. In many countries, weak arrangements exist for the judicial enforcement of corrective action; moreover, the array of remedial measures does not address conditions leading up to insolvency and is too limited. It may not be possible, for instance, to impose fines on managers and board members individually.

Other Principles: Observations related to other principles include:

- About a third of reviewed countries show weaknesses in capital adequacy (CP 6). Capital ratio requirements are applied extensively, but in many cases only toward credit risk. In many countries they are still calculated and applied on a non-consolidated basis. In some cases, banks are allowed to operate with inadequate capital for long periods of time, and no corrective actions are taken.

- About a third of reviewed countries have weaknesses in internal controls (CP14). Not many countries have formulated detailed guidance on internal controls, though generic references in the law are quite frequent. Moreover, a comprehensive review of bank internal controls is not always an integral part of the examination process. Clear criteria to evaluate the composition of the board and management board and, consequently, legal powers to require changes in case the criteria is not met, are not well established.

- Slightly less than a third show deficiencies in off-site supervision (CP18). Some supervisory systems are in the process of establishing off-site surveillance units, upgrading their computer equipment and are developing analytical tools and technical analysis. A frequent weakness is the lack of financial statements and prudential returns submitted on a consolidated basis.

42. An important underlying limitation in many countries is that supervisory practice often tends to be "compliance-oriented" with over-reliance on rules and regulations, versus "risk-oriented" supervision where a more forward looking, incisive type of supervision needs to be exercised, and enforcement action also needs to capture unsafe and unsound banking practices.

III. Experience with the Assessment Process[22]

43. In order to alleviate resource needs associated with FSAP and OFC programs, the Fund and the Bank have concluded arrangements with cooperating supervisory agencies and central banks to share experienced staff to participate in the assessments. In this way, the composition of assessment teams will differ from country to country. However, the use of different experts and staff, in countries with varying levels of development can give rise to issues of consistency of assessments across countries, as has become clear now that more assessments are published. In order to help address these issues, the Fund and Bank staffs have developed a number of assessment tools to supplement the Methodology prepared by the Basel Committee, including:

- Guidance notes on what areas to address in the assessments; and
- Standardized templates for FSAP assessments and ROSC modules. These templates also include standardized templates for action plans to address developmental needs identified by the assessment and standardized outlines for the FSAP report chapters on the main findings of the assessments.

44. At the initiative of the Bank-Fund Financial Sector Liaison Committee, FSAP outreach meetings have been held, in order to draw lessons from the assessment experience of both the assessed countries and the assessors. In this context, a "Technical Review of Strengthening the Assessment of Financial Sector Standards," was held in November 2001, bringing together experts that had participated in assessments on BCP, IOSCO Core Principles and Core Principles for Systemically Important Payment Systems (CPSIPS). Most recently, an overall review of the FSAP and its lessons was held in Washington, D.C. in January 2002.[23]

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[22] See Box 4 on the BCP assessment process.

[23] The Bank and Fund are currently preparing a Board paper on the review of experiences with the FSAPs.

Box 4. Basel Core Principle Assessment Process

Pre-mission

Once a country has requested an assessment and the details have been agreed upon, questionnaires on the structure and performance of the banking sector are sent to the authorities of the country and to the assessors. At this point, generic templates for the assessments are also included, as is the BCP Methodology along with extensive guidance notes on what to cover in the assessment. The authorities are requested to return the responses to the questionnaires and a self assessment to the mission chief as soon as possible, preferably in advance of the mission. Also a request is made to send any relevant legislative and regulatory materials. Simultaneously, experts are recruited from designated cooperating supervisory bodies or central banks.

Mission

The experts discuss compliance with the 25 BCPs with the banking supervision authorities, private sector counterparts and other relevant government representatives. Factual information on the banking sector is collected, and an assessment reached. Together with any comments, these elements are formatted into a standardized template. This standardized approach facilitates an objective, systematic and consistent assessment, and also provides better comparability across countries. The results of the assessment are normally discussed with the authorities prior to departure of the mission, and left in the field for their written comments. On the basis of the assessment an action plan is designed to address identified weaknesses.

Post-mission

After return of the mission, the assessment is circulated for comment, as appropriate, to staff within MAE and the Bank, as well as to pre-approved outside experts. After clearance within the Bank and MAE, the respective area department and PDR comments on the assessment. Following a second clearance by MAE, the draft report is discussed with the authorities during the Article IV mission, and is finalized. On the basis of the FSAP assessment, a ROSC is prepared for inclusion in the FSSA. If the authorities agree to publish the FSSA, as they are encouraged to do, the FSSA is posted on the Fund's external website. The authorities may agree to publish only the ROSC.

45. These discussions have shown that some BCPs are more difficult to interpret and assess than others. Moreover, differences of views exist how to use the classification "not applicable." Some experts consider a BCP not applicable when a country is not materially engaged in the kind of banking business addressed by the BCP in question. Others will consider that if a certain type business can be undertaken, or is already being undertaken by a small group of institutions, the country needs to implement the BCP. In any case, the assessment would at least need to specify that even if a certain activity is not taking place, the regulatory system should offer the option to rapidly introduce additional regulation should the need arise.

46. Some authorities have pointed to divergences in assessments from one team to another; other authorities believe that some assessments place too much emphasis on country particularities while other authorities would prefer a more country-specific approach. Some authorities would like to see a more systematic follow-up in the form of technical assistance.

47. Drawing on the experience of staff, experts, and country authorities, the November 2001 Technical Review Meeting highlighted the need for:

- Greater consistency in assessments, for instance through better pre-mission preparation of the countries and the assessors, better guidance and documentation, more support during the assessment process, more rigorous review; designation of a Bank/Fund mission contact person, as well as a contact person with the country authorities; better information on the nature of the FSAP/OFC assessment and on the work to be delivered from the expert;

- Better incorporation of macro-micro and cross sector linkages into the assessments, for instance through more discussion between economists and BCP experts during missions, involvement in the development and conduct of stress tests, and mission-wide financial sector discussions;

- Facilitation and preparation of the BCP assessment, through carefully conducted country self assessments, possibly without providing individual BCP ratings;[24]

- More guidance on a number of interpretation issues:

    1) How to measure the level of practical implementation of the BCP, versus "paper" implementation by the issuance of laws and regulations, given the time constraints of the missions.

    2) How to incorporate the preconditions into the assessment process within the context of an FSAP and how to assess some of the BCPs which assessors considered difficult to assess, for instance BCP 1 (especially independence), BCPs 2 (permissible activities for banks), 13 (other risks), 14 (internal controls), 22 (remedial action), and 23-25 (cross border banking).

    3) How to rate BCPs that are highly dependent on compliance with the preconditions, or that have strong interlinkages, such as BCPs 1 and 22, 6 and 8, 11 and 14, 12 and 13, 6 and 20, 9, 10, 18, and 23.

    4) How to draw the line between the ratings "largely compliant" and "materially non-compliant."

    5) How to assess BCP1; as a single principle or as six different ones. The Methodology states that four of the component parts are not repeated elsewhere in the Core Principles and that the two other components are developed in greater detail in one or more of the subsequent BCPs. Individual assessment of the components of BCP 1 provides more insight into the weaknesses, which in some cases, such as on

[24] See Basel Committee on Banking Supervision Publication No. 81: "Conducting a Supervisory Self-Assessment—Practical Application," Basel, April 2001, prepared with Fund and Bank cooperation.

supervisory independence, touch upon the preconditions for effective banking supervision.

6) How to assess BCP 15, in light of the more detailed and wide-ranging AML/CFT assessment methodology.

- Confirmation of the "four-eyes-principle" for assessments. More emphasis should be placed on selecting supervisors with a broad and diverse experience: a combination of on-site inspection and off-site analysis-expertise; two assessors from different supervisory traditions; at least one assessor with prior FSAP experience;

- A need to keep the assessors involved in the follow-up work after the mission;

- More structured TA to address developmental needs identified by the FSAPs and OFC assessments; and

- More attention to the specific circumstances of the assessed country, without jeopardizing uniform application of the assessment criteria.

48. In order to upgrade the assessment process, more time needs to be allocated to performing an assessment than is currently available in the typical FSAP timeframe. Alternatively, more lead time can be blocked off for pre-FSAP work in collecting, translating and studying relevant laws, regulations and other material. The resource implications of this need to be considered, however.

Notwithstanding the inherent difficulty in applying some of the Principles in different countries as well as the unavoidable reliance on the individual assessor's judgment, the Fund and the Bank have tried to address some of these issues, partly as a follow-up of the Technical Review Meeting:

- As indicated above, guidance notes and standardized templates have been developed to improve depth, clarity, and presentation of the assessments. Moreover, discussions are regularly held with the authorities and assessors to obtain useful feedback on how to strengthen the assessment process;

- A standardized briefing note has been prepared for assessors, providing information on FSAP preparation, documentation, the review process, and appropriate contact persons at the Bank and the Fund;

- A standardized memorandum has been prepared for country counterparts, describing the FSAP process, preparation, questionnaires and templates to be completed, and providing the names of appropriate contact persons;

- A roster of pre-approved experts has been assembled to assist in the review of the assessments, thus providing quality and consistency control, while relieving staff of some of the review tasks;

- The Bank/Fund Financial Sector Reform and Strengthening (FIRST) initiative (see Box 5) proposes to coordinate the post-assessment allocation of TA resources pledged by a group of developed countries, as well as from the Bank and the Fund.

Box 5. The Financial Sector Reform and Strengthening (FIRST) Initiative

FIRST is an international initiative jointly undertaken by the Fund, the Bank and national development agencies, including the U.K. Department for International Development, the International Development Agency of Canada, and the State Secretariat for Economic Affairs of Switzerland. Discussions are in progress with other donor institutions with the aim of expanding the scope of the initiative. This partnership will build on the two key initiatives: the Financial Sector Assessment Program and Reports on the Observance of Standards and Codes.

Many developing countries do not have the resources or expertise to follow up on the findings of these programs. FIRST has been designed to respond quickly to requests for assistance, to access worldwide expertise, and to be flexible in the type and method of technical assistance it provides. FIRST offers such countries the assistance they need while ensuring that developing countries themselves take charge of the reform process. This far-reaching initiative will complement and support technical assistance in strengthening national financial sectors from other providers, including the Fund and the Bank, through highly targeted, responsive projects proposed to it directly by developing countries and their advisors.

FIRST will provide technical assistance grants to low and middle-income countries for short and medium-term projects in the areas of capacity-building and policy development. By strengthening national financial sectors, FIRST will support economic growth and, in turn, poverty reduction. This will also contribute to crisis prevention and the establishment of a more stable international financial system. As an example, countries that wish to improve financial supervision or accounting standards would be able to seek FIRST funding to achieve these reforms.

Source: www.firstinitiative.org

IV. RECENT DEVELOPMENTS RELEVANT TO THE BASEL CORE PRINCIPLES

48. Since the adoption of the BCP a number of developments have taken place in the area of banking, financial markets and prudential supervision that impact the assessment program, as well as the content of the Principles themselves.

A. Financial Market Developments

49. ***Developments in financial markets***: Three main developments in the financial markets since 1997 need to be taken into consideration in a review of the BCPs and the Methodology: continued internationalisation of financial markets, the blurring of boundaries between the traditional financial sub-sectors banking, insurance and securities, and acceleration of financial sector consolidation.[25] All these changes demonstrate an increasing need for cooperation and coordination in regulations and practices between domestic and international financial supervisory agencies to establish a consistent group-wide supervisory framework. This would comprise supervisors from different sectors and countries, which can effectively supervise a multinational financial conglomerate.[26]

50. ***Emergence of Large and Complex Financial Institutions (LCFIs):*** Although also a more recent development in financial markets, the emergence of LCFIs and the ongoing development of techniques to supervise these institutions, needs to be mentioned separately, in view of the unique issues and problems associated with it. The potential impact of LCFIs on financial system stability (see Box 7) will require review of the relevant BCPs and their Methodology. The BCPs already emphasize the need for effective supervision of a group at both individual entity and consolidated levels and the need for effective consultation and information-sharing between the domestic and foreign supervisors of the entities within the group. Certain important aspects of supervision of LCFIs might call for further enhancement of the BCP, for instance: how to better match capital levels to the risk profiles of LCFIs; how to address the unsupervised components of the group; how to address issues related to cross-border insolvency of a group, how to further develop effective cross sector and cross border supervision, and the extent to which coherent and transparent accounts can be produced for such groups on a consolidated basis.

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[25] Work on Consolidation in the Financial Sector: Group of Ten, January 2001.

[26] See Box 6 on the work of the Joint Forum on cross-sector comparison of CPs.

Box 6. Joint Forum—Cross-Sector Comparison of Core Principles

The "Joint Forum," a working group including representatives from banking, securities, and insurance supervisors as well as representatives from the IMF and World Bank, issued a report in 2001 comparing the Core Principles issued by the BCBS, IOSCO and IAIS. The effective implementation of supervision, based on the Core Principles of each sub-sector, might be hampered by potential divergence or contradictions between the sets of Principles.

Although no significant contradictions between the three sets of Core Principles were found, divergences occurred for the following reasons:
- There are intrinsic differences between the three sub-sectors, which are reflected in the respective CPs.
- The primary objective of regulation and supervision is different between the sub-sectors.
- The CPs were drafted at different times, when different issues were in focus.
- The structure, objectives and mode of work differ between the standard-setting bodies.

Two examples where standards diverge are:
- The definition of regulatory capital and the requirements for capital
- The definition and treatment of various types of risks.

The Joint Forum report proposes various solutions to deal with divergence:
- Editorial solutions without changing the core principles themselves, i.e. a matrix in which the corresponding clauses in the three sets of CPs are put beside each other for quick reference.
- Cross references to corresponding issues in the other sets of CPs.
- Modification of content of existing core principles, by harmonizing key definitions, for instance of capital and risk measurement and reviewing core principles relating to group-wide supervision
- Consultation between the standard-setting bodies for each sub-sector with the other standard-setters when Core Principles are revised.

Source: Core Principles: Cross-sector Comparison. The Joint Forum. November 2001.

Box 7. Operational Paper on Large Complex Financial Institutions (LCFIs): Issues to be Considered in FSAP

The main focus of the paper is on the assessment of the relevance of LCFIs to the financial stability of those countries that are either the location of the headquarters of a LCFI or are hosts to LCFI group affiliates that are prominent in international financial markets.

With its focus on individual countries, the FSAP process has inherent limitations with regard to the assessment of risks and vulnerabilities associated with LCFIs. Country FSAPs generally only cover part of the activities of LCFIs given their international nature. Even if local supervision of an LCFI is effective in identifying and mitigating local risks as far as possible and there is good co-operation with the LCFI's home regulator(s), a host country is unlikely to fully escape the effects of a failure in the home country. The FSAP should focus only on those aspects over which the member's authorities can reasonably be expected to exert an influence.

The paper outlines a four-stage approach for the evaluation of the systemic risks that may be posed by the activities of LCFIs and of the authorities' policies to mitigate these risks. Stage I involves the identification of the scope and scale of LCFIs' activities within the local financial system. Stage II involves an assessment of the major systemic risks arising from the different businesses of LCFIs. Key concerns will be not only potential direct losses in the event of an LCFI failure but also contagion risks. Stage III involves an assessment of the effectiveness of the authorities' policies and practices in addressing these risks. Finally, stage IV includes a summary of the main risks identified by the FSAP team and recommendations to the authorities.

Source: MAE OP/02/3 on LCFIs: Issues to be considered in FSAP.

B. Developments in Banking Supervision

51. ***Development of financial soundness indicators:*** Increased awareness of the linkages between the cyclical movements in the macro economy and the health of the banking sector has led to the continued refinement of a system of financial soundness indicators.[27] The use of financial soundness indicators implies a more system-wide approach to banking supervision. Financial soundness indicators can help signal deteriorating conditions in the economy that can impact the banking sector at a later stage. They fit into the shift in perspective that is gradually taking place among supervisory agencies towards complementing the micro-prudential perspective with the increased awareness of the macro-prudential linkages. The ultimate objective of this is to limit the likelihood of failure, and the associated cost, of significant

[27] "Macro-prudential Analysis: Selected Aspects," IMF Occasional Paper No. 212 (Washington: International Monetary Fund, June 2001).

portions of the financial system. Thus, an expansion of focus is taking place not only to concentrate on depositor protection, but also to consider and to safeguard systemic stability.[28]

52. ***Development of anti-money laundering and combating the financing of terrorism (AML/CFT) standards:*** Future FSAPs will need to devote increased attention to AML/CFT measures by banks and to supervisory monitoring of these measures. From a banking supervisory viewpoint the main risks of AML/CFT are to the integrity and reputation of banks that are contaminated by these activities. Terrorist financing is not explicitly mentioned in BCP 15. In light of the recently enhanced scope and comprehensiveness of the assessment of countries' AML/CFT policies and practices, coordination between BCP 15 and these assessments will need review. The draft AML/CFT Methodology significantly expands the number of criteria that countries need to meet (see Box 8).

53. ***Dealing with weak banks, bank intervention and bank insolvency***: As work continues on developing techniques to deal with weak banks [29]and bank intervention[30] there may be a need to revisit the relevant BCPs and Methodology. The challenges that cross border bank resolution and liquidation pose to supervisors need to be taken into account. Remedial measures and intervention are in many cases difficult to take as a result of weak

judicial systems, insufficient independence of the supervisory authority, or a culture of forbearance. A correct balance between rigid prompt corrective actions and a more flexible framework for supervisory intervention needs to be sought.

[28] Andrew Crockett, "Marrying the Micro-and-Macro-prudential Dimensions of Financial Stability," Basel, September 2000.

[29] Basel Committee on Banking Supervision, "Dealing with Weak Banks," Basel, March 2002.

[30] World Bank/IMF initiative on Bank Intervention and Insolvency.

Box 8. AML/CFT Standards and Assessment Methodology

The November 2001 communiqués of the IMF and Development Committee reflected the priority attached to this effort by the two organizations and contained recommendations for international actions. In response to this call, the Fund and the Bank have each developed and are implementing detailed action plans.

An expanded methodology circulated to the Boards of the Fund and the Bank in March 2002, draws heavily on the criteria necessary for an effective AML regime, developed by the BCBS, IOSCO, and IAIS, but extends it in three directions:

- CFT (combating the financing of terrorism) elements are integrated into the methodology along with AML elements;
- A separate new section in the Methodology has been developed on the legal and institutional AML/CFT framework; and
- A section in the Methodology has been developed covering nonprudentially regulated financial services providers.

This expanded AML/CFT Assessment Methodology has been applied to all FSAP and OFC assessments since February 2002 on a pilot basis. Additionally, a specific questionnaire has been distributed, in the context of Article IV consultations, to an initial group of 38 member countries. It is envisaged that the questionnaire will be expanded to all members. A single comprehensive methodology for assessing the FATF 40+8. Recommendations has not yet been agreed upon among Fund and Bank staff and the FATF, leading to different assessment requirements for countries. Although differences remain, there is now a movement toward convergence on the main components that a single methodology should incorporate.

Source: Intensified Work on AML/CFT. Report prepared by MAE, LEG, and World Bank, 2002.

54. ***Need for further international guidance on loan classification and provisioning***: Increased awareness of the need for sound practices on loan classification and provisioning[31] has highlighted the need for more international guidance. To support the new capital accord, it is necessary to develop more precise guidance on accurate loan classification and provisioning, without which capital calculations are seriously flawed. In many banking crises, asset classification and valuation was found to be especially weak and misleading. Although the BCBS has started work on this issue, in particular in the document "Sound Practices for Loan

[31] "Loan Classification and Provisioning Among Members of the Basel Core Principle Liaison Group,"(Washington: World Bank), forthcoming.

Accounting and Disclosure,"[32] more specific guidance is needed in many countries, for instance on provisioning levels, and the use of collateral and its valuation.

Also, the relationship between the internal ratings based approach under Basel II, which takes loss experience into account, and the traditional approach to dealing with expected losses through loan classification and provisioning, needs to be examined.

55. ***The role of state-owned banks:*** The past years have brought increased awareness of the risks and problems associated with state owned banks. In many member countries, long ignored problems in state owned or controlled banks are causing major quasi fiscal and credit allocation problems. Often they operate under preferential supervisory regimes, thus distorting competition and hiding losses. The role of these institutions will need to be taken into consideration when reviewing the BCP and the Methodology. One way to address this issue could be to bring the current Appendix 1 to the BCP into the main body of the document, and to include it in the assessment exercise.

56. ***Enhanced awareness of the importance of good external auditors in the supervisory process:*** [33] In many countries, the external audit process does not reliably perform its intended role, i.e. of verification of the quality of the financial statements of an institution. Furthermore, supervisors often rely on external auditors to perform on site inspections, certify prudential returns on a periodic basis, certify the annual statements of banks, and provide opinions on internal administrative systems of banks. Good accounting and auditing is also crucial for sound lending decisions of banks, the preparation of consolidated statements and prudential returns, as well as for accurate asset valuation, capital calculation, prevention of circumvention of prudential standards, and for better quality information to the markets and the public. Assessors should also review whether and under what conditions banks' external auditors have the authority to report directly to the supervisors, and whether these powers are actually used. In light of these conditions, assessments may need to cover the quality of the accounting profession in that country, based for instance on the availability of training, requirements for entry into the profession, and the independence of external auditors, which are generally contracted and paid by the banks. In this context, BCPs 17, 18 and 19 and the associated Methodology criteria may need adjustment.

57. ***Increased awareness of the importance of good governance and transparency:*** Increased awareness of the need for governance and transparency standards for banks and supervisory agencies[34] will need to be taken into consideration for a new generation of BCP and the Methodology. Sound governance objectives are indicated across many of the existing Core Principles. Raising the importance of sound bank governance by making it more clearly defined

[32] Bank for International Settlements, Basel, July 1999.

[33] The Enron case may lead to tighter oversight of the accounting industry and tougher corporate disclosure rules in many countries.

[34] Principles of Corporate Governance (OECD) and Code of Good Practices on Transparency in Monetary and Financial Policies (IMF).

and more explicit within the context of the Principles will help facilitate the increasing emphasis on risk based supervision (and thus bank board and management responsibilities and accountability). Nonetheless, sound governance and the ability to address such through the supervisory process will further enhance the effectiveness of bank oversight. Furthermore, good governance in supervisory agencies can promote better policies in banks as supervisors gain enhanced credibility.[35] Greater transparency of banking supervision policies can be expected to contribute to the education of the public on banking sector and supervisory issues and contribute to more effective market discipline and greater stability.

58. ***The shift from compliance oriented supervision to risk-based supervision***: In many countries, a shift is underway from solely compliance based supervision to a more risk oriented form of oversight. This shift is likely to be reinforced when countries implement the new Basel Capital Proposals, and under the impact of financial innovations. The BCP and the associated Methodology may need review, in order to assess whether the current BCP and Methodology are sufficiently flexible to accommodate this shift to a more qualitative aspect of banking supervision.

59. ***The new Basel Capital Accord (Basel II):***[36] Although still a consultative document and subject to change, the proposals for a new Basel Capital Accord to replace the 1988 Accord will have a major impact on the formulation of the BCP. The current Basel Capital Accord was finalized in 1988 and developments in banking and regulation, a number of which are described above, have made it necessary to update the Accord. The present Accord only focuses on a limited number of risk categories and risk weights. Basel II takes a more "holistic" approach to banking supervision than the 1988 Capital Accord. It will encompass most of the core aspects of general banking regulation and supervision as well as elements of disclosure and market discipline.

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[35] See Das, Udaibir, and M. Quintyn (2002), "Crisis Prevention and Crisis Management—The Role of Regulatory Governance," *paper presented at the 4th Annual Financial Markets and Development Conference "Building Pillars of Financial Sector Governance: The Roles of the Public and Private Sectors." (New York, April 17-19, 2002). Forthcoming as IMF Working Paper*

[36] See Box 9 on Basel II. The BSBC plans, provided there is political approval, to issue the new Capital Accord in 2003. In order to give countries time to adapt their legislation to introduce Basel II, the implementation is not envisaged before 2006. The BCBS has no powers to take legally binding decisions, but makes a recommendation to the G10 Central Bank Governors. They concluded a "gentlemen's agreement" among themselves to promote that the Basel Committee recommendation be transformed into national law.

Box 9. Basel II

The proposals for a new Basel Capital Accord (Basel II), will affect capital regulation, but will also influence the way in which banking supervision is conceived and conducted. Basel II is also based on the understanding that minimum capital requirements are in themselves not enough to ensure a safe and sound banking system. The new framework will be more comprehensive and sensitive to banking risks than the current 1988 Capital Accord. The emphasis will be put on banks' own assessments of risks, and incentives will be provided to banks to further improve their risk measurement and management systems. To achieve these goals, Basel II is structured in three mutually reinforcing pillars:

Pillar I: Minimum capital requirements include capital charges for credit risk and operational risk, in addition to the capital charges for market risk established in 1996. Pillar I provides an evolutionary structure for the calculation of these capital charges; that is, banks with a greater level of sophistication are allowed to use increasingly advanced methodologies. For credit risk, this evolutionary structure includes the standardized approach, conceptually similar to the 1988 Capital Accord, although allowing a greater degree of risk weight differentiation based on external ratings, and the internal ratings-based (IRB) approach, which relies on banks' internal assessment of the components that define the risk of a credit exposure. The IRB approach, in turn, comprises two different methodologies: the foundation and advanced IRB approaches, depending on the sophistication of risk management systems of the banks. A similar structure applies for operational risk. This new, risk-sensitive framework is strengthened with the introduction of rules for wider recognition of credit risk mitigation techniques and new rules for the treatment of asset securitization.

The proposals are geared to broadly maintain the current level of regulatory capital, and do not intend to raise or lower the overall level of capital requirements. However, these may increase or decrease for individual banks depending on their risk profiles. As the proposals are more finely attuned to banking risks, banks with good risk management systems and/or low risk profiles, may have lower capital requirements, and thus find incentives to move towards better risk management systems and practices. .

Pillar II: The supervisory review process, closely linked to the Basel Core Principles, goes beyond verifying that banks comply with minimum capital requirements, and ensures that banks' capital is aligned with their level of risk and degree of sophistication. Pillar II is based on four principles: (i) the bank is primarily responsible for calculating and maintaining a proper level of capital; (ii) supervisors have the ability to evaluate banks' internal capital adequacy measures; (iii) supervisors have the ability to require banks to hold capital above the minimum when they estimate that capital levels are not adequate; and (iv) supervisors have the ability to intervene at an early stage and enforce remedial actions if bank capital falls below prudential levels.

Pillar III: Market discipline is a powerful tool that introduces strong incentives for banks to put in place safe and sound risk management policies and practices. Pillar III focuses on the core disclosures relevant to exercise effective market discipline: asset quality, amount of capital, risk profile and capital adequacy, as well as information on the details of internal systems of banks adopting the IRB approach.
Source: The New Basel Capital Accord. BCBS: www.bis.org/publ/bcbsca.htm

V. Implications for Supervisory Standards and Their Assessment

A. Implications for the Standard-Setting Body

60. The key role of the BCP as the accepted global standard for effective banking supervision has reinforced the place of the BCBS as the authoritative standard setter in this area.

61. In order to maintain the relevance of the assessment process, the BCP and the assessment methodology must be reviewed periodically to incorporate the experience of the assessment process as well as new market and prudential developments. At the same time, standards should not be revised so frequently as to become "moving targets," which many countries may not be able to implement in time. There should be a trade-off between setting "state of the art" international standards, and the avoidance of "regulatory fatigue" in countries that need to implement these standards.

62. Guidance issued by the BCBS needs to balance the need for universally acceptable standards against the need for standards that accommodate different backgrounds and systems. The joint IMF-World Bank document entitled "Technical Review on Strengthening the Assessment of Financial Sector Standards"[37] emphasizes that calibrating the BCP, or modifying the assessment criteria to fit the specific circumstances of countries, would be contrary to the Basel Committee's intended objective of viewing the BCP as the standard aimed at universal adoption and implementation. The risk of imposing unachievable standards is mitigated by the policy of the BCBS to closely involve non G-10 countries through the Core Principles Liaison Group, which has been instrumental in the definition of both the Core Principles and the Assessment Methodology.

Review of the Basel Core Principles and the Methodology

63. The BCP prove to have been well formulated, and to stand up well in the face of the new challenges. However, a review will be needed to assess to what extent the issues raised above can be accommodated into the current principles or whether additional principles are advisable. The Methodology may also need to be reviewed. New assessment criteria may be needed in some cases, while in others, a shift from "additional" criteria to "essential" may be enough. A third element in ensuring that the BCP continue to address current issues can be the issuance of additional detailed technical guidance papers by the BCBS.

64. As the review of compliance and the assessment process has shown, the preconditions can have a profound impact on the potential to comply with the BCPs. Therefore, more methodological guidance on their evaluation is advisable. Although in some cases new international guidance has been issued since the publication of the BCP[38] or experience has highlighted the main aspects that such guidance should cover, there are others where further

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[37] "Technical Review on Strengthening the Assessment of Financial Sector Standards," Joint Bank-Fund Financial Sector Liaison Committee, Washington, D.C., March 2002.

[38] "Guidance for Developing Effective Deposit Insurance Systems," FSF, September 2001.

work needs to be done, for instance, on the linkages between the macro-economy and the banking sector. Preconditions might be addressed in two non-mutually exclusive ways: first, assessors would review in more detail certain infrastructure elements comprised by the preconditions and which support effective supervision, and, second, assessors would review what actions regulators and supervisors might undertake to countervail the negative impact of the lack of such preconditions on safe and sound banking and on effective supervision. Such a review might require that additional expertise, for instance in the legal or accounting area, be added to assessment teams. Furthermore, coordination will be needed when some of the preconditions are also relevant to other standards, as is likely to be the case for—for instance—the IAIS or IOSCO standards.

65. In some countries, the assessors may determine that the preconditions are not complied with. Although this will severely impact the overall level of compliance, also in these cases the BCP assessment should continue, as the assessments have been found very useful by the countries involved, as well as by the Fund and the Bank. Second, it is desirable to avoid an interruption of the program. Third, future assessments will also need to deal with other events that have an impact on the level of compliance, such as the introduction over time of a new generation of BCPs.

66. **Furthermore, additional guidance is needed on several principles**. For instance, there is a need to consider possible ways to strengthen supervisory independence (BCP 1.2), in particular ensuring appropriate governance arrangements for supervisory agencies—clear mission statements, adequate arrangements to support accountable decision-taking processes, effective channels of communication to ensure that staff and supervised institutions fully understand the policies and procedures, or ways to address conflicts of interest. Principle 8 on loan classification and loss provisioning should be complemented with more precise guidelines on loan evaluation, income recognition, collateral valuation, establishment of loan loss allowances, and credit risk disclosure.[39] Furthermore, a number of other principles need more methodological guidance, such as the supervisory regime for state banks, credit risk management and connected lending and large exposures, management of other risks, consolidated supervision, corporate governance for banks, information requirements, remedial measures and cross border banking. In some cases, as the BCBS[40] has already issued guidelines covering some of these issues, the only need will be to update accordingly the BCPs or the Methodology.

[39] BCBS "Sound practices for Loan Accounting and Disclosure," Basel, July 1999.

[40] Since the introduction of the BCP in 1997, a wealth of additional guidance has been issued, by the BCBS itself or in collaboration with other standards setters, in a range of papers. Over the past years, papers have been issued on such topics as how to deal with weak banks, the relationship between banks' external auditors and bank supervisors, management and supervision of operational risk, risk management for electronic banking, highly leveraged institutions, and settlement risk in foreign exchange.

67. *Regarding the new Capital Accord:* Many components of Basel II may be addressed in the present BCPs, since they are parts of generally accepted international standards for effective supervision. However, some important new aspects are not dealt with, or only briefly mentioned by the current BCPs. The new Accord will only become operational at the beginning of 2007, and its proposals are not currently a part of the accepted standards for effective banking supervision. Nevertheless, the proposals cast their shadow ahead, and will impact thinking on the revision of the current BCPs. The following paragraphs are aimed to briefly describe only the most important implications for the content of the BCPs:

- For Pillar I of the proposals, the BCPs do not seem to imply major changes. They are sufficiently broadly formulated, and seem able to incorporate banks' more risk oriented capital adequacy systems, also using the internal ratings-based (IRB) approach. The Methodology may require additional criteria, for instance, to facilitate assessment of supervisory capacity to judge and potentially reject banks' IRB systems,[41] or the acceptability of rating agencies and export credit agencies as sources of input for the standardized approach. More specificity may be needed in the BCPs and the Methodology to support prudential standards in newly prominent areas such as credit risk mitigation, interest rate risk, operational risk, and securitization.

- Pillar II implies significant additional responsibilities for supervisors, including, for instance, evaluating banks' internal capital assessment processes or selecting which credit rating agencies are acceptable. Possibly more emphasis will be needed on BCP 1, i.e., addressing the ability of the supervisory authority to do its job, particularly in terms of having sufficient discretionary powers balanced with a suitable framework for transparency and accountability, and an adequate staff. Stronger formulation may be needed for the legal protection of supervisory officials in this more discretionary environment that Basel II envisages. More emphasis may be needed on encouraging supervisory arrangements that allocate resources and design regulatory programs that take into account banks' systemic importance, for instance focusing more intensely on those banks whose risk profile or operational experience warrants such attention or categorizing banks with regard to their capital ratio and requiring a certain level of capital in order for a bank to engage in certain activities or to make certain acquisitions. More explicit language may be needed on appropriately frequent and effective interaction between supervisors and banks, an area, which Pillar II emphasizes and which is not always well developed.

- Pillar III puts increased emphasis on market discipline and requires banks to disclose more information. Supervisors will need adequate powers to ensure that banks' management disclose appropriate and accurate information. In the present BCP little mention is made of the need for public disclosure of banks' financial information. The current text of BCP 21 is too limited to support Pillar III requirements.

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[41] This is the approach that is envisaged in the BCP for VaR-models for market risk (CP 12, additional criterion 3: "The supervisor who does not have access to the adequate skills and capacity does not allow banks to determine their regulatory capital requirements based on sophisticated models, such as VaR").

68. As shown above, there will be room for differences in country implementation. However, differences should not lead to regulatory arbitrage. In order to improve supervisory convergence, the BCBS has established an Accord Implementation Group, where bank regulators from different countries will exchange their experiences on applying Basel II. The conclusions of this forum, and also any future interpretations of Basel II by the BCBS itself, will also have an impact on the interpretation of the BCPs and of the assessment criteria.

69. *Other developments in financial markets and banking supervision,* as indicated in the previous chapter, affect the BCP in several ways and they will need to be taken into account when reviewing the BCP, for instance, the effectiveness of the supervisory arrangements and the ability of the supervisors to exercise oversight over LCFIs. More guidance is advisable on dealing with weak banks that takes into account the progress of the work that is underway. More specific guidance on loan classification and provisioning needs to be provided. State owned banks tend to play a problematic role in many developing country financial sectors that may need specific mention in the BCP. More attention needs to be paid to issues of bank and supervisory agency governance and transparency. An underdeveloped area that requires more prominence in assessments of supervisory practices is that of international cooperation between financial sector supervisors.

70. ***Coordination with other standard-setting bodies***: Moreover, standards on securities, insurance, payment system oversight, corporate governance, and transparency of monetary and financial policies, will need to be taken into account[42] in keeping the BCP and the assessments up to date. A revision of the BCP should take into account the need for coordination with the CPs of other sectors, without weakening the BCP.

71. Standards on accounting and auditing practices are especially relevant to the BCP. Supervisors should have an interest in the quality of accounting standards and encourage their effective implementation, in view of their importance for the proper measurement of banks' capital and profitability.[43] More emphasis should be given to the importance of such standards, and the role of the supervisors, working closely with the banking industry and the accounting profession, in encouraging their implementation. Furthermore, the role of the auditor's work in the supervisory review process will need to be reviewed.

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42 The "Compendium of Standards," an initiative of the FSF, highlights 12 key standards requiring priority implementation: Code of Good Practices on Transparency in Monetary and Financial Policies (IMF); Code of Good Practices in Fiscal Transparency (IMF); Special Data Dissemination Standard/ General Data Dissemination System (IMF); Principles of Corporate Governance (OECD); International Accounting Standards (IASC), International Standards on Auditing (IFAC); Core Principles for Systemically Important Payment Systems/Recommendations for Securities Settlement Systems (CPSS/IOSCO);The Forty Recommendations of the Financial Action Task Force/8 Special Recommendations Against Terrorist Financing (FATF); Core Principles for Effective Banking Supervision (BCBS); Objectives and Principles of Securities Regulation (IOSCO) and Insurance Core Principles (IAIS). www.fsforum.org.

43 Review of International accounting standards, BSBC, April 2000; The Relationship Between Banking Supervisors and Banks' External Auditors, BSBC, December 2001, and Audits of the Financial Statements of Banks, IAASB, December 2001.

72. Especially any standards to be issued by the newly created International Association of Deposit Insurers (IADI)[44] will be relevant to the BCP, as in many countries deposit insurance agencies have substantial roles in banking supervision or interact closely with the banking supervision authority. New BCPs will need to take issues of deposit insurance into account, or carve these issues out, and leave them for the IADI to deal with. Issues could specifically arise with regard to remedial actions against non-compliant banks.

B. Implications for Assessed Countries

73. The adoption in 1997 of the BCP has shaped the agenda of many supervisory authorities worldwide. Because of this effect, many supervisory authorities have taken concrete steps aimed at upgrading their regulatory and supervisory systems with a view to achieving compliance. Furthermore, the assessment process, based on the BCP and the Methodology, supports further convergence of individual country standards with the international standard, thus promoting financial stability.

74. The assessment of compliance with the BCPs is not an end in itself. Some jurisdictions may have given too much prominence to being rated favorably since their main concern was to obtain a "good assessment" especially relative to peers. Arguably, a distorted assessment, which would not have thoroughly revealed actual weaknesses, would compromise the goal of developing an action plan to correct shortcomings. Although it has been specified that all countries are to be assessed[45] against the "essential criteria," it is likely that many of the "additional criteria" will be considered essential in an updated version of BCP, which provides a roadmap for supervisory authorities to take action in anticipation of the "upgrading" of these criteria.

75. ***External BCP Assessments or Self Assessments:*** Countries should feel encouraged to request BCP assessments. While the BCP assessments conducted as a part of the FSAP/OFC program provide an external, independent view of country compliance, countries should also perform their own assessment of compliance based on the BCBS guidance document. Fund and World Bank assistance can always be requested for this process. The assessments will help define an agenda for further improvement of the subject supervisory systems, serve as a basis for identifying TA needs, and promote convergence of standards and practice.

76. ***Need to develop an agenda for regulatory and supervisory reform***: Once an assessment is completed, countries often need to amend their legal and regulatory framework. This requires convincing lawmakers that amendments or more fundamental reform is needed, particularly in the case that preconditions require reinforcing. In many instances, the objective of attaining full compliance may also necessitate upgrading of IT systems and internal procedures and provision of training. Moreover, better banking supervision or the introduction of legal and regulatory reform is often slowed by a shortage of qualified human and financial resources. Thus, not all the expected benefits from the FSAP and BCP assessment process have been obtained. Countries

[44] "Guidance for Developing Effective Deposit Insurance Systems," FSF, September 2001.

can be more pro-active in requesting technical assistance from donor organizations or bi-laterally.

77. Emerging countries might reject a revision of the BCP, especially regarding the incorporation of Basel II, because they are just in the process of implementing some of the recommendations included in the 1997 BCP. Furthermore, implementing new amendments will require, in many countries, significant investments in more resources and training. However, this fact should not prevent the revision, as the BCP document states[46] "banking supervision is a dynamic function that needs to respond to changes in the marketplace. Consequently, supervisors must be prepared to reassess periodically their supervisory policies and practices in the light of the new trends or developments. A sufficiently flexible framework is necessary to enable them to do this."

C. Implications for the Fund, Bank and Other Agencies

78. The assessment process will tend to mirror the evolution of banking supervision as reflected in the BCP. Assessments will need to cover more areas and will require a broader range of expertise, in order to assess a wider variety of banking supervision systems, as countries use the options in the Basel II framework. These developments raise a number of issues. Maintaining the relevance of the assessment effort will also require these agencies to review what changes in assessment procedures, as well as assessment follow-up, are needed.

79. ***Consistency of assessments:*** As shown during the November 2001 Technical Review meeting, the consistency of the assessments is a concern of many countries participating in the program. The publication of many assessments invites cross-country comparison. As indicated above, a number of actions have already been taking by the assessor agencies to address the issue of consistency.

80. Currently all assessments must be carried out on the basis of the agreed-upon Methodology, which comprises very specific criteria (more than 200) that greatly facilitate the conduct of assessments as well as dialogue between assessors and those countries receiving the assessment. The risk of inconsistency is also mitigated by the development of additional assessment tools by the assessing agencies, and outreach meetings to provide an opportunity for countries to comment on the assessment process and compare experiences. The "four-eyes-principle" is applied as much as possible, implying that two assessors are deployed, each from a different supervisory tradition. Furthermore, initiatives have been taken to prepare guidance notes, standardized assessment templates, and briefing notes for experts and participating countries. However, at the Paris Technical Consultations in November 2001, assessors also pointed out that the combination of two different supervisory traditions could give rise to friction and lengthy debates within the team and/or with the country authorities.

81. ***Cross-sector assessments***: A related issue is how to coordinate the assessors' work across sectors. Since an increasing number of countries are beginning or have already integrated

[46] See "Core Principles for an Effective Banking Supervision," Basel, 1997, page 9.

supervision across the various financial sectors (typically banking securities, and insurance or a combination thereof), the assessment process should likewise reflect this configuration.

82. ***Technical assistance:*** One of the key objectives of any BCP assessment is to identify any technical assistance needs the country may have to implement its post-assessment reform program. In order to improve systematic and coordinated TA follow-up procedures, the FIRST was developed. This initiative envisages systematic delivery of follow-up technical assistance to countries that have been assessed, and thus also creates incentives to volunteer for an assessment. FIRST will seek to provide support in implementing recommendations emanating from the assessment reports. It will also provide support for countries strengthening their financial systems and implementing standards and codes prior to formal inclusion in the ROSC/FSAP programs. There is no "one-size-fits-all" model for supervising banks, and TA may differ in content.

83. In this context, a key issue that will need further discussion is how to incorporate weaknesses identified in the preconditions, that in many cases are beyond the supervisors' domain, into the prioritized action plan at the end of the assessment and, therefore, into focused and well coordinated TA.

84. ***Dissemination:*** Once standards have been adopted, ensuring proper dissemination to all supervisory authorities is key to their adoption going forward. Aside from the Bank and the Fund, the task of disseminating Basel standards is also assigned to the Financial Stability Institute (FSI). This institution also serves as the training arm of the BCBS. It organizes workshops and seminars on the latest developments in banking supervision, with input from other agencies, including the Bank and the Fund. The FSI also facilitates dialogue and experience-sharing among supervisors, through meetings and seminars. Also the FSF has been advocating the dissemination of the results of BCP assessments and other standards as a means of improving the quality of decisions and/or behavior of market participants, which in turn should contribute to enhancing stability of the global financial system.

85. ***Training and Resources***: The introduction of Basel II, and other new elements in banking supervision, will require that assessors may need training to be fully up to date on developments, in order to be able to perform a proper assessment. There will be a need to train Bank and Fund staff in new supervisory techniques, as they will frequently be playing a coordinating role in the assessment process. As the scope of assessments widens, additional assessment staff may be required to join assessment missions. There will be a need for training and pre-mission guidance on how to assess the practical implementation of the BCP.

86. ***The BCP and the Financial Action Task Force (FATF):*** As the AML/CFT standards evolve and become more specialized, and the assessment methodology specifically for AML/CFT is finalized, the issue arises as to how to align the assessment of BCP 15 with the use of AML/CFT methodology. The BCP assessors had, until recently, worked without the benefit of close ties with the FATF and the Bank/Fund AML/CFT experts. But, with the objective of adopting adequate AML/CFT policies, strengthening coordination and cooperation among

BCBS, IOSCO, IAIS, World Bank, IMF, FATF and the Egmont Group[47] has become an absolute necessity. The AML methodology being drafted by the Fund and the Bank has greatly benefited from input provided not only by FATF but also by other standard setters, including the Basel Committee.[48]

VI. Conclusions

87. As shown by the results of the survey, the assessment process is a valuable tool to gain insight into the quality of banking supervision across countries, set development priorities and provide a baseline for technical assistance efforts. As the survey shows, compliance with a number of critical BCPs has been poor. Future assessment missions may need to focus more closely on these identified areas.

88. Assessments need to focus especially on supervisory independence, loan classification and provisioning, credit policies, AML/CFT, consolidated supervision, remedial measures, supervision of LCFIs and cross border supervision and cooperation.

89. The role of the BCP Preconditions needs to receive more emphasis, in view of their importance for the relevance of the overall assessment, and consideration needs to be given to bringing them into the assessment process. This may require a broader assessment exercise, the development of guidelines for evaluation, and potentially, access to broader expertise by the assessment team.

90. Consistent with the BCP Methodology, more emphasis is needed during the assessment process on the actual implementation of the BCPs, in addition to evaluating the legal and regulatory framework. A more thorough evaluation of BCP implementation is a function of adequate staffing of the assessment team, and the available time. Methods need to be developed to incorporate this aspect into the assessments in a more structured way.

91. A meaningful assessment process relies on periodic review of the BCPs and the assessment process, in order to incorporate recent developments. Outreach and review meetings need to be repeated at a suitable periodicity. At these meetings, the impact of recent market and prudential developments can also be discussed.

92. A number of factors will increase the complexity of BCP assessments: (i) the need to include the Preconditions in the assessment; (ii) the need to place more emphasis on the assessment of actual implementation; (iii) the need to take recent developments into account

[47] The Egmont Group began in 1995 as an informal group when a number of "Financial Intelligence Units (FIUs)" started working together. The goal of the group is to provide a forum for FIUs to improve support to their respective national anti-money laundering programs.

[48] See BCBS guidance papers "Customer Due Diligence," Basel, October 2001; and "Sharing of Financial Records Between Jurisdictions in Connection With the Fight Against Terrorist Financing," Basel, April 2002.

such as LCFIs; and finally (iv) the implementation of Basel II. This greater complexity will require more training, assessment time and specialized resources.

93. As more emphasis is being placed on the AML/CFT assessments, the BCBS and the AML/CFT standard setters will need to coordinate the scope of their respective assessment activities and develop a clear and practical understanding on this issue.

94. In view of the continued role of the Fund and the Bank in conducting the assessments, and their contributions to promoting international financial stability, the Fund and the Bank will need to continue their role as the main counterparts of the standard-setting bodies and assessed country authorities, and remain closely involved in the process of the adaptation of the standards to new developments.

95. The demand for technical assistance from assessed countries, to help them address any deficiencies appearing from the assessments, is likely to increase. Assessed countries have raised the issue of better coordinated TA after the assessments. The FIRST initiative, supported by the Bank and the Fund, is a welcome development towards more effective and better-coordinated follow-up TA.

96. More analysis is needed to establish linkages between compliance with the BCP and financial stability, within a country, regionally and globally.

Overview of World Compliance with BCPs

Figure 1. Compliance with BCP: Total Countries
(In percent)

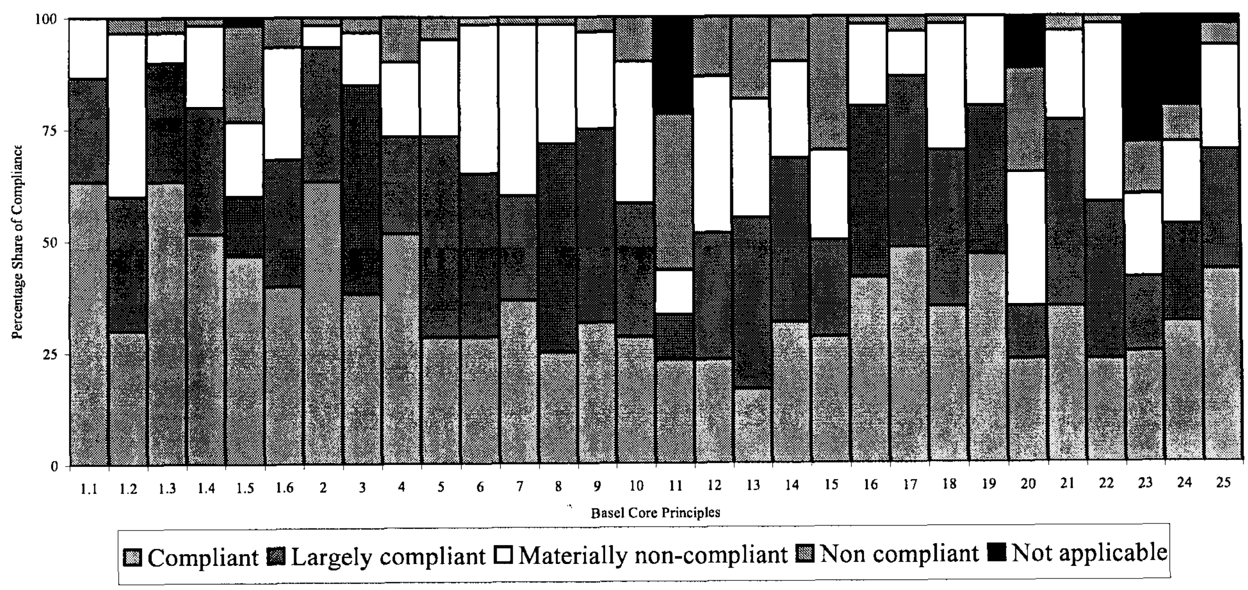

Figure 2. Compliance with BCP: Advanced Economies
(In percent)

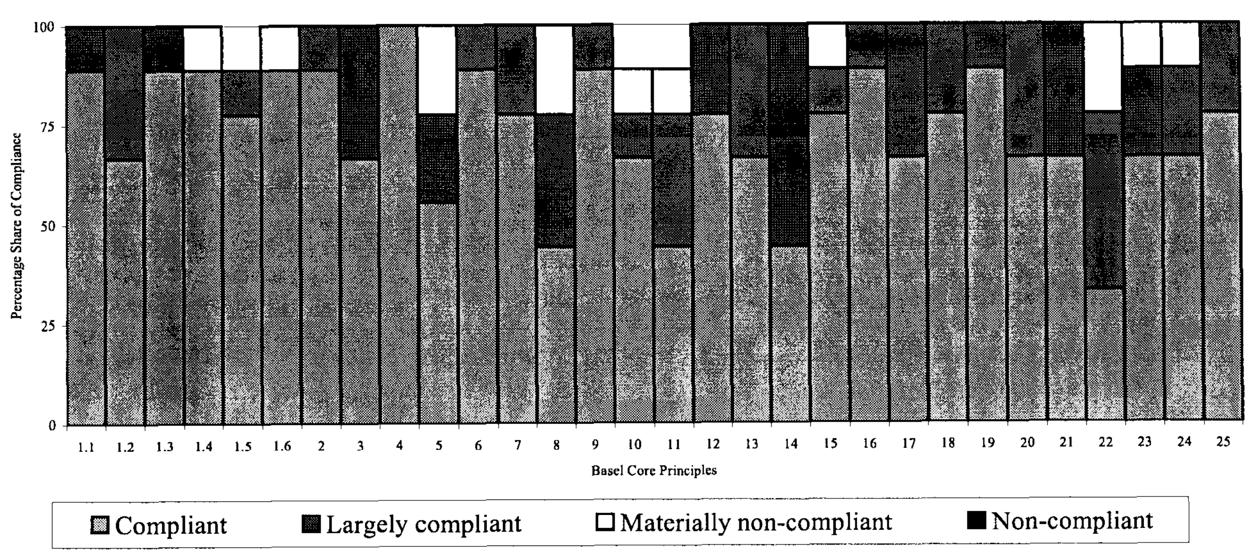

Figure 3. Compliance with BCP: Developing Countries
(In percent)

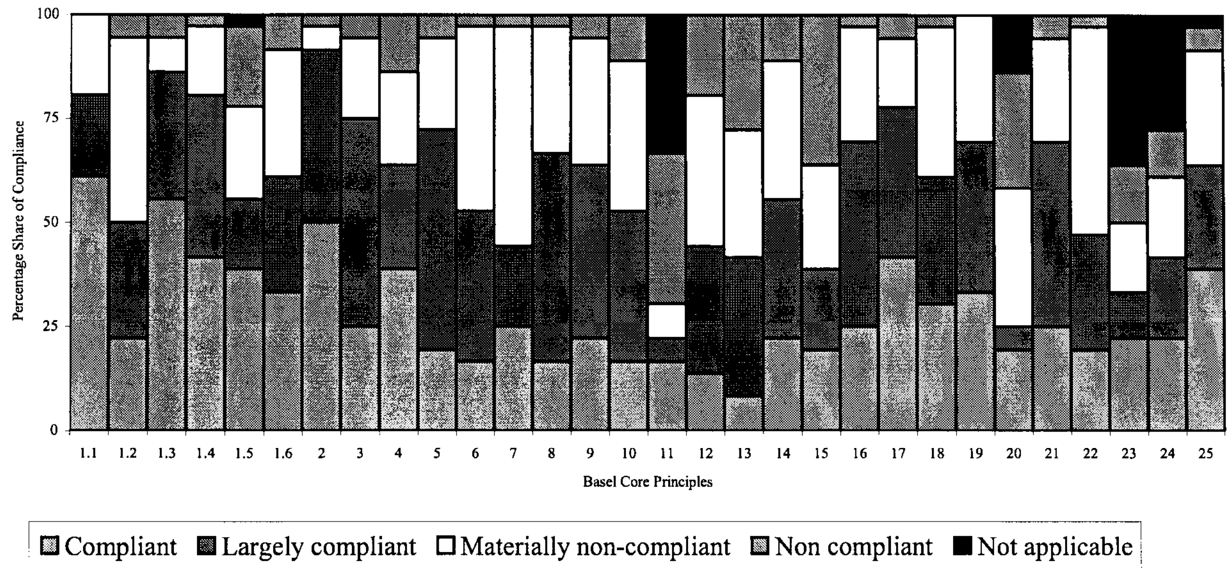

Figure 4. Compliance with BCP: Transitional Countries
(In percent)