SM/08/289
Correction 1

September 17, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Implementation of the Basel Core Principles for Effective Banking Supervision—Experience with Assessments and Implications for Future Work**

The following factual corrections to SM/08/289 (9/3/08) have been provided by the staff:

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 6, para. 1, lines 6-7: for "...Central and Eastern Europe, and 29 countries each from Western Europe and Latin America/Caribbean regions."
read "...Central and Eastern Europe, 29 countries from Western Europe, and 31 from the Western Hemisphere region."

Typographical Errors

Page 4, line 3: for "135 assessments" read "136 assessments"

Page 6, para. 1, line 3: for "135 assessments" read "136 assessments"

Page 8, para. 6, line 4: for "135 jurisdictions" read "136 jurisdictions"

Page 15, Table 3, line 8, column 1: for "Western Hemisphere (29)"
read "Western Hemisphere (31)"

Page 18, Table 4, line 4, column 4 (2003-2004): for "36" read "37"

Page 18, Table 4, **line 5, column 4 (2003-2004)**: for "13" read "14"

Questions may be referred to Mr. Narain, MCM (ext. 39616).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (5)

Other Distribution:
Department Heads

Glossary

BCP	Basel Core Principles
BCBS	Basel Committee on Banking Supervision
C/LC	Compliant/Largely Compliant
CP	Core Principles
FSA	Financial Services Authority
FSAP	Financial Sector Assessment Program
FSSA	Financial System Stability Assessment
FATF	Financial Action Task Force
IAIS	International Association of Insurance Supervisors
IFIs	International Financial Institutions
ILG	International Liaison Group
IOSCO	International Organization of Securities Commissions
LAC	Latin America and Caribbean
LCFI	Large and Complex Financial Institution
MENA	Middle East and North Africa
MNC/NC	Materially Noncompliant /Noncompliant
OFC	Offshore Financial Center
ROSC	Report on Observance of Standards and Codes
RTAC	Regional Technical Assistance Centers
TA	Technical Assistance
WH	Western Hemisphere

EXECUTIVE SUMMARY

This paper reviews the experience to date in assessing countries' compliance with the Basel Core Principles for Effective Banking Supervision (BCP). This review is based on 13~~5~~6 assessments conducted under the FSAP/OFC programs, using the methodology associated with the 1997 version of the BCP. It follows earlier reviews presented to the Board in 2000, 2002, and 2004. The Fund has developed a strong collaborative relationship with the Basel Committee in promoting financial stability, in particular, in its work through the FSAP program in assessing (together with the Word Bank) the quality of countries' supervisory structures. Experience gained from these assessments are also being reported back to the Committee through the Fund's participation in Basel working groups, and staff has also been actively involved in the update of the BCP in 2006, with the objective of maintaining the BCP's relevance as a global standard of good practice.

The findings suggest that while countries have made improvements in strengthening their supervisory frameworks, weaknesses were identified in key areas of prudential regulation and supervision. Overall, there is a relatively high degree of compliance in the principles related to the legal and institutional framework for supervision and the authorization and conduct of banking business. However, more than 40 percent of the assessed countries did not comply with the essential criteria of the principles dealing with risk management, consolidated supervision, and the abuse of financial services. More than a third did not possess the necessary operational independence to perform effective supervision nor have adequate ability to use their formal powers to take corrective action.

The paper also highlights significant differences in compliance both by region and by income level. On average, countries in Western Europe demonstrated a much higher degree of compliance (above 90 percent) with the BCP than their counterparts in other regions. Similarly, the findings suggest that more efforts have to be made to strengthen the supervisory framework in Africa and in countries in the Western Hemisphere. In general, high-income countries reflected a higher degree of compliance than their lower- and middle-income counterparts. Notwithstanding, as evidenced in the ongoing market turbulence, implementation weaknesses in consolidated supervision, risk management, remedial action, and crisis management frameworks also exist in mature markets.

The overall findings suggest that continued efforts are needed to strengthen banking supervision in many jurisdictions. Countries themselves will need to address these areas. Moreover, there may be a need for additional technical cooperation in coordination with other donor countries and institutions. Technical cooperation efforts will need to be directed, in particular, at areas in which compliance is uniformly low and which have proven to be particularly critical in the current crisis for financial stability.

The recent revision of the Core Principles and the implementation of Basel II will place greater demand on countries, on assessments, and technical assistance resources. The revisions of the BCP strengthen the assessment criteria, but also increase their number and scope. Moreover, while Basel II implementation will strengthen the supervisory frameworks, the transition has to be managed carefully to ensure that the supervisory capacity and other preconditions for its effective application are in place. For countries implementing Basel II, assessment of the capital adequacy, supervisory practices, and disclosure frameworks will become more complex. At the same time, there will be renewed interest in assessing the interaction between supervisory frameworks and global financial stability, as evidenced by the crisis in financial markets in industrialized countries.

Going ahead, the coverage of assessments will have to be reviewed in light of the resource constraints imposed by the shrinking budget envelope. Assessments based on the revised BCP standard will place increased demands on both staff and the assessors. In the absence of increasing resources devoted to full assessments, smarter ways will have to be found to maintain assessment quality and develop techniques to monitor progress while continuing to promote greater transparency. This is particularly relevant as most assessments in the future will be in the nature of updates in which ROSCs are typically not produced, as the standard is not assessed in full. Staff is separately developing a proposal for a targeted approach to standards reassessments. This proposal contemplates ROSCs will be produced based on a reassessment of selected principles comprising a given standard. Moving to such a targeted approach poses several significant challenges, and staff will separately present their proposals at a later date on how these challenges can be met.

I. INTRODUCTION

1. **This paper reviews the findings of the Fund/Bank in conducting Basel Core Principles assessments and identifies key issues and challenges facing banking systems in their implementation**. It incorporates findings from 13~~5~~6 assessments conducted under the FSAP/OFC programs and updates earlier reviews to the Board in 2000, 2002, and 2004. In terms of regional coverage, it includes 19 countries each from Asia, Africa, MENA, and Central and Eastern Europe, and 29 countries ~~each~~ from Western Europe and 31~~Latin America/Caribbean regions~~ from the Western Hemisphere region. The BCP underwent significant revisions in 2006, and although a few assessments using the revised methodology have been completed, these are excluded from the current review.

2. **The Basel Core Principles of Effective Banking Supervision were formulated by the Basel Committee on Banking Supervision in 1997 as a framework of minimum standards for sound practices in banking supervision**. The associated assessment methodology was developed in 1999. Since then, these principles have been used by the IMF and World Bank as the standard against which banking systems of member countries are assessed, and they are a key element of the FSAP and the ROSCs. A strong and effective framework of banking supervision, as reflected in high compliance with these standards, has long been seen by national supervisors as an essential prerequisite for financial stability. Recent empirical studies (Box 1) also support this view.

Box 1. Establishing an Empirical Link Between Compliance with the Basel Core Principles and Financial Stability

In the first such effort, Sundararajan et al. (2001) reviewed the 35 initial BCP assessments conducted by the IMF/World Bank and established an indirect effect of compliance on credit risk and bank soundness through interaction with other macroeconomic and banking sector factors.1/ Based on their findings, they argued that interpretation of compliance should therefore be in the context of other macro variables that affect banking risks and soundness. With the benefit of a larger sample of assessments, two recent papers suggest much stronger benefits of compliance. Podpiera (2006) explores the relationship between banking sector performance and the quality of regulation and supervision, as measured by compliance with the BCP for 65 countries, and finds a significant positive impact of compliance on performance, as measured by asset quality and bank efficiency.2/ Kunt et al. (2006) study BCP compliance data for 39 developed and emerging market countries from IMF/WB assessments and conclude that there is a positive correlation between bank soundness and an overall index of BCP compliance, with this effect being more pronounced for principles dealing with information requirements and transparency.3/

1/ V. Sundararajan, D. Marston, and R. Basu, 2001,"Financial System Standards and Financial Stability: The Case of Basel Core Principles," IMF Working Paper 01/62.

2/ Richard Podpiera, 2006, "Does Compliance with Basel Core Principles Bring Any Measurable Benefits?," *Staff Papers*, International Monetary Fund, Vol. 53, No. 2.

3/ A. Demirgüç-Kunt, E. Detragiache, and T. Tressel, 2006, "Banking on the Principles: Compliance with Basel Core Principles and Bank Soundness," IMF Working Paper 06/242.

3. **The Fund, together with the Bank, has actively supported the Basel Committee's efforts in developing guidance for bank supervisors worldwide through their participation in its various sub-groups and working groups**. Fund and Bank staff participates in meetings of the International Liaison Group (ILG), its working group on capital, the Research Task Force, and the Accord Implementation Group's Validation sub-group. The Fund has reported to the Committee on the experience gained from the BCP assessments and suggested areas where further guidance could be beneficial. Staff has provided inputs into strengthening the 1997 Core Principles and the associated methodology, and has participated in the drafting and steering groups set up by the Committee to revise the BCP. Staff has also worked with the Committee on developing guidance in areas such as provisioning, dealing with weak banks, and preparing for Basel II implementation. Currently, Fund/Bank are partnering with the ILG in developing a methodology for assessing Basel II implementation in national jurisdictions.

4. **The rest of the paper is organized as follows**: Section II elaborates on the main findings of this review, focusing on those areas in which less progress has been achieved, as reflected in compliance with the related Core Principles. Section III highlights key developments related to the assessment methodology, including the revision of the standard in 2006 and the incorporation of elements of the Basel II framework. Section IV discusses the implications of the main findings and the recent developments on the work of the Fund.

II. Experience with BCP Assessments

5. **The 2004 review[1] identified credit risk management, capital adequacy, consolidated supervision, and AML as areas where compliance was relatively low**. Unlike the earlier reviews in 2000 and 2002 (Box 2), the 2004 review was cross-sectoral in scope and attempted a more integrated view of standard assessments. It covered 90 assessments (including 20 conducted as part of OFC assessments) and considered compliance of all three financial sector standards viz. BCP, IAIS Core Principles, and IOSCO Core Principles. With regard to the BCP, it concluded that notwithstanding better compliance by industrialized countries, relative strengths and weaknesses existed across all country-income groups (industrialized, emerging, and developing). It noted that the broad area of credit risk management had relatively low rates of compliance across all jurisdictions. In addition, it identified the areas of capital adequacy, consolidated supervision, and KYC/AML as being relatively weak from the compliance perspective.

[1] International Monetary Fund, "Financial Sector Regulation: Issues and Gaps," August 2004.

Box 2. Main Findings of the 2000 and 2002 Reviews

The first (2000) review, based on 26 assessments, concluded that countries had much work to do to achieve compliance with many of the Core Principles.1/ The review suggested that significant resources, including those from the Fund and Bank, would be required to assist countries to build their capacity in this regard. It identified the drafting of legislation and regulation, and building institution capacity for improved and effective supervision, as key areas of future work. Among individual CPs, it found lowest levels of compliance with those related to credit polices; country, transfer, market and other (liquidity and operational) risk; internal controls; anti-money laundering; consolidated supervision; and remedial measures. It accepted that the sample was too small to draw far-reaching conclusions relating to compliance with macro characteristics (only one industrialized country was included), but did suggest that these findings were spread across all regions. Finally, it suggested that when the CPs were revisited, attention should be paid to incorporating accounting issues, disclosure issues, and exit procedures for banks.

The second (2002) review was based on 60 assessments and identified three key reform themes.2/ First, it called for a more explicit assessment of the preconditions of the BCP, and that those related to problem bank resolution and safety nets be incorporated in the BCPs themselves. Second, it called for strengthening of the independence of supervisory agencies and, for this purpose, suggested that guidelines for good governance of the supervisory agencies were needed. Third, it called for guidance on good practices on loan classification and provisioning. It reaffirmed the findings of the first review and also suggested that additional guidelines were advisable in the area of supervision of LCFIs, cross-border cooperation, supervision of state banks, corporate governance of banks, and management of operational risk.

1/ International Monetary Fund, "Experience with Basel Core Principle Assessments," April 2000.

2/ International Monetary Fund and the World Bank, "Implementation of the Basel Core Principles for Effective Banking Supervision, Experiences, Influences, and Perspectives," September 2002.

A. Main Findings of the 2008 Review

6. **Overall, this review shows that continued work is needed on strengthening banking supervision in many jurisdictions, particularly in the area of risk management**. This (2008) review covers the experience of the full set of BCP assessments conducted in 13~~5~~6 jurisdictions (including OFCs) between 1999 and 2006, before the changeover to the revised methodology. It corroborates many of the findings of the earlier reviews (Box 2) with regard to the main trends in compliance with the BCP and suggests continuing weakness in certain areas. In the following paragraphs, these findings are presented by principle, by region, by country income level, and by year of assessment.

B. Compliance by Core Principle

7. **There has been a significant strengthening of the legal and institutional framework for supervision and the authorization and conduct of banking**. Figure 1 lays out the global compliance position[2] by principle and Table 1 highlights those principles with

[2] Global compliance for each BCP (as, for example, in Figure 1 and Table 1) is computed by taking the percentage of assessed countries which are rated as compliant (fully or largely) for that principle. For this paper, (continued)

70 percent in Central and Eastern Europe, (which includes several EU accession countries), and is lower at around 55 percent in Africa and Western Hemisphere countries. However, this regional data masks individual country compliance. In terms of principles with least compliance, there are some regional variations (Table 3) with KYC/AML issues being relatively more prominent in Asia and Africa, legal protection for supervisors in Central and Eastern Europe, and internal audit and control in LAC.

Table 3. Leading Areas of Low Compliance by Region

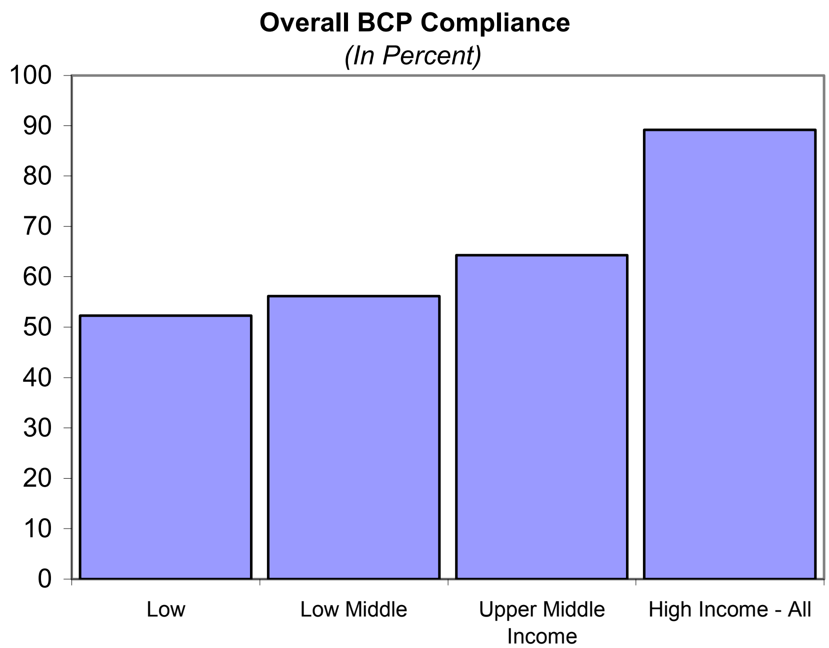
Core Principles	Countries Not in Compliance (In percent)	Core Principles	Countries Not in Compliance (In percent)
Asia (19)		Africa (19)	
Abuse of Financial Services	63	Abuse of Financial Services	79
Country Risk	53	Market Risk	79
Other Risks	53	Other Risks	74
On and Off-site Supervision	53	Country Risk	68
Credit Policies	47	Formal Powers of Supervisors	68
Western Hemisphere (~~29~~31)		MENA (19)	
Market Risk	65	Market Risk	58
Capital Adequacy	61	Other Risks	58
Consolidated Supervision	61	Consolidated Supervision	58
Other Risks	58	Country Risk	47
Internal Controls and Audit	55	Abuse of Financial Services	47
Eastern Europe (19)		Western Europe (29)	
Consolidated Supervision	63	Formal Supervisory Powers	14
Country Risk	58	Country Risk	10
Market Risk	58	On/Off Site Supervision	10
Legal Protection for Supervisors	47	Loan Classification/ Provisioning	10
Independence/Resources Other Risks, Abuse of Financial Services, Cross-border	37	Acquisitions and Investments	10
		Independence/Resources	10

Source: International Monetary Fund.

D. Compliance by Income Level

20. **While the assessments indicate both strengths and weaknesses across all income groups, high-income countries do better on compliance than their lower-income peers**. High-income countries reflect a much higher degree of compliance (89 percent) than the low (52 percent), low-middle (54 percent), and upper-middle income (64 percent) countries. This suggests that there will be a continued strong demand for technical assistance in strengthening banking supervision for developing and emerging countries for the next few years.

Figure 3. BCP Compliance by Income Level



Source: International Monetary Fund.

21. **Shortcomings in the supervisory framework in the mature economies have contributed to the recent turmoil in the mature financial markets resulting from the sub-prime crisis**. The causes of the turmoil have been investigated in several forums and inadequate supervision has been accorded some share of the blame in the chain of events. The report of the Financial Stability Forum (FSF),[6] for example, points to poor underwriting standards; shortcomings in firms' risk-management practices; poor investor due-diligence; poor performance by the credit-rating agencies; incentive distortions, including in the Basel I framework; and weaknesses in disclosure and liquidity risk management as key contributory factors, which were fed by an environment of an exceptional credit boom and low interest rates.

[6] Financial Stability Forum, "Report on Enhancing Market and Institutional Resilience," 2008.

22. **Although BCP assessments overall reflect a high degree of compliance in these economies, they do flag some of the fault lines that have been revealed in the wake of the current crisis**. The United States, where the sub-prime crisis originated, has not yet been assessed. However, examples from the BCP assessments of the United Kingdom and Germany (which are published) are illustrative. Even though both countries demonstrated a very high degree of compliance, the assessors had observed the need for further strengthening of some key areas For instance, the United Kingdom report points out that no special statutory insolvency procedures existed for banks and the FSA had a limited role in statutory insolvency procedures. It cautioned that under the system, the treatment of depositors like other creditors could delay repayment of depositors by several weeks. In addition, it has made recommendations on increasing staffing capacity for supervising the trading of highly complex products, developing an approach to liquidity management, and identifying off-site monitoring triggers. In Germany's case, the BCP assessment points out the need for issuance of guidance on "other" risks (liquidity, operational, and interest rate risk) appropriate to the operations of different banks and also calls for instituting proactive measures for identification and treatment of weaknesses in institutions, as well as the introduction of explicit rules to take action in specified timeframes.

23. **The experience of the industrialized countries that have been affected by the recent financial turmoil suggests that while compliance with the BCP is an important indicator of the strength of the banking supervision it cannot rule out problems in the banking system**. Assessments are important in identifying weaknesses that may contribute to or exacerbate banking sector problems. Compliance at a point in time cannot, however, rule out problems developing subsequently in individual banks or groups of institutions, nor can it foreshadow the implications of changes in the regulatory environment. It must be supplemented with effective bank resolution frameworks, safety net mechanisms, and crisis-management arrangements.

24. **Drawing lessons from the turbulence, several actions have been proposed to strengthen supervisory frameworks**. In its recent report,[7] the FSF has called for firms to strengthen their risk-management practices and for supervisors to strengthen prudential oversight of capital, liquidity, and risk management, and to enhance the supervisory assessment of banks' valuation processes to strengthen disclosures. It has also called for authorities to strengthen their responsiveness to risk through better cooperation and exchange of information, including the assessment of financial stability risks and coordinated action for large global banks. The Basel Committee is expected to announce upgraded guidance relating to some of these areas later this year.

25. **The Fund and Bank will contribute to these efforts through their membership of the various groups of the standard-setting bodies**. In addition, developing more systematic

[7] Ibid, p.16.

means of following up on the findings of the FSAP and BCP assessments and monitoring progress through the regular surveillance process, as well as in scheduling FSAP updates and programming technical assistance, would be an effective response.

E. Compliance by Assessment Year

26. **Overall, compliance has improved over time**. The table shows how overall compliance has improved by year of assessment, with the rate of noncompliance (obtained by averaging over assessments covered in a period) going from 36 percent in 1999–2001 to 17 percent in the assessments concluded in 2005–2006. This may be driven by a host of factors, including the scheduling of the assessments, with the proportion of low- and middle-income countries in the sample trending downwards over this period, and increased occurrence of substantive updates in later years. However, assessors also point to the role of the increased awareness and absorption of the standards with time, greater integration, and information sharing among jurisdictions. National authorities, with encouragement from the IFIs, have also made a significant effort to adopt the Core Principles.

Table 4. Compliance Based on Assessment Period

	Composition of BCP Assessments 1999–2006 (In percent)			
	1999–2000	2001–2002	2003–2004	2005–2006
Average noncompliance rate	36	25	24	17
Number of assessments	**23**	**58**	**376**	**18**
High Income	4	20	143	8
Middle Income	12	31	15	8
Low Income	7	7	8	2

Source: International Monetary Fund.

27. **Nonetheless, this picture of compliance is a static one, prevailing at the time of the assessment, and does not reflect improvements made subsequently**. While the factual updates of the assessment conducted in the context of FSAP updates and occasional coverage in the Article IV often suggest significant improvements in compliance with principles earlier identified as noncompliant, these are not currently captured in a systematic manner to enable comparison. A sample of 16 assessments where substantive updates have been conducted using the same (1997) methodology enables a better comparison, showing that compliance rates increased from 72 percent to 84 percent for the countries covered. This suggests that the assessments may have an important role in identifying and conveying key weaknesses and that national authorities have been receptive to this advice.