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To: Members of the Executive Board

From: The Secretary

Subject: **Toward a Framework for Financial Stability**

The attached revised paper on toward a framework for financial stability incorporates changes as well as some technical revisions in response to comments from a number of countries. As indicated in EBS/97/38, Revision 1, Supplement 3 (8/22/97), it may be necessary to make some further editorial changes in the final version of this paper to reflect changes in the **Core Principles** paper when that paper is revised early in September.

Mr. Folkerts-Landau (ext. 37665) or Mr. Lindgren (ext. 37151) is available to answer technical or factual questions relating to this paper.

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Toward a Framework for Financial Stability

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August 25, 1997

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INTRODUCTION

1. It is now well recognized that vulnerable and unstable banking systems can severely disrupt macroeconomic performance in industrial, developing, and transition economies alike.[1] The widespread incidence and the high cost of banking problems have prompted calls for concerted international action to promote the soundness and stability of banking systems. At the Lyon Summit in June 1996, the G-7 countries called for "the adoption of strong prudential standards in emerging market economies," and encouraged the international financial institutions to "increase their efforts to promote effective supervisory structures in these economies."[2] These intentions were reinforced by the Interim Committee's "Partnership for Sustainable Global Growth" in September 1996.[3] In Denver, in June 1997, the G-7 Ministers of Finance meeting considered a report by a G-10 working party on financial stability in emerging market economies[4] and requested "the IMF and the World Bank to report to Finance Ministers next April on their efforts to strengthen the roles they play in encouraging emerging market economies to adopt the principles and guidelines identified by the supervisory community".[5] The G-7 Heads of Government then called "on the international financial institutions and the international regulatory bodies to fulfill their roles in assisting emerging market economies in strengthening their financial systems and prudential standards". The Heads of Government also welcomed "the IMF's progress in strengthening surveillance and promoting improved transparency. Increased attention to financial sector problems that

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[1]These issues have been extensively discussed elsewhere. See C-J. Lindgren, G. Garcia, and M. Saal, *Bank Soundness and Macroeconomic Policy* (International Monetary Fund, 1996); and D. Folkerts-Landau and Takatoshi Ito, *International Capital Markets—Developments, Prospects, and Key Policy Issues* (International Monetary Fund, World Economic and Financial Surveys, August 1995 and September 1996) .

[2]Economic Communique of the G-7 Heads of State and Government, Lyon, France, June 28, 1996.

[3]Communique of the Interim Committee of the Board of Governors of the International Monetary Fund, IMF Press Release No. 96/49.

[4]*Financial Stability in Emerging Market Economies: A strategy for the formulation, adoption, and implementation of sound principles and practices to strengthen financial systems.* A report of a working party, comprising representatives of the Group of Ten countries and emerging market economies.

[5]Final report by Ministers of Finance to the Group of Seven Heads of State and Government on Promoting Financial Stability, Denver June, 21, 1997.

could have significant macroeconomic implications, and to promoting good governance and transparency, will help prevent financial crises".[6]

2. International financial institutions and official groupings (Bank for International Settlements (BIS), the Basle Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Group of Ten Deputies, the World Bank, regional supervisory groupings, and the Fund) are responding to these concerns in their respective work programs. The Basle Committee has been in the forefront of this effort with the release of its "Core Principles for Effective Banking Supervision," in April 1997. These principles have quickly become the focal point for the increased efforts to strengthen financial sectors around the world by providing a blueprint for enhanced banking supervision and they provide the foundation for the framework described in this paper.

3. The Fund, with its near universal membership, has an important role to play in this ongoing international effort. The Fund can help assure broad dissemination of the work of various organizations, particularly that of the Basle Committee. To this end, the "Core Principles" are attached as Annex I. Moreover, with its broad responsibility to engage in surveillance of member countries' economic policies, the Fund can assist in identifying potential vulnerabilities in the monetary and financial systems, and in the external positions of member countries, and it can assist the authorities in formulating corrective policies.

4. The existing limitations on staff resources and expertise imply that an increase in Fund surveillance coverage of financial sector issues—as part of its ongoing bilateral or multilateral surveillance activities—will focus on identifying those weaknesses in the financial systems, particularly in the banking systems, of member countries that could potentially have major macroeconomic implications. Fund surveillance cannot be expected to address all the areas in the financial system that are in need of improvement, nor can it be expected to provide specific assistance to the regulatory and supervisory authorities in meeting their day-to-day challenges. Furthermore, in many member countries, banks remain the principal financial intermediaries for allocating and pricing credit and financial risk, and for making payments, as well as being the main source of financial leverage. Hence, the Fund's efforts to enhance its work on financial system soundness will focus on the banking system, although attention will also need to be paid to those parts of the rest of the financial system that are potential sources of major difficulties.

5. Fund surveillance over banking sector issues of macroeconomic significance, and staff discussions on appropriate remedial measures with the authorities, will be enhanced and facilitated by a general statement of the broad principles and characteristics of stable and sound financial systems. This paper suggests such a general framework, based on a generally agreed body of knowledge and experience. The application of this framework to individual

[6]Statement by the Group of Seven Heads of State and Government, Denver, June 21, 1997.

countries will, of course, require careful consideration of country-specific circumstances as member countries' priorities for attainment of best practices will be different, based on their different traditions, existing structures, and resource constraints.

6. This framework is not a check list of issues to be raised in every Article IV consultation with member countries. Rather it is intended to suggest broad categories of issues—and some detailed points within those categories—of particular importance for the discussion of financial sector issues of potential macroeconomic importance. Furthermore, consideration of issues in these broad categories, as part of the continuous process of Fund surveillance, can help identify circumstances where issues should be taken up with country authorities, sometimes on a more urgent basis than is permitted by the regular Article IV consultation schedule. Also, it is hoped that by promoting broader understanding of the requirements for sound banking and effective financial intermediation more generally, the development and promulgation of this framework—along with other similar efforts under way outside of the Fund—may contribute to the general international effort to improve the soundness of financial systems, and thereby reduce the likelihood and diminish the intensity of future financial sector problems.

7. A number of official and industry groupings have for some time been compiling best practices, and formulating principles and guidelines, for use in the relevant sectors of the financial system.[7] The efforts of these groups, in particular those of the Basle Committee, have proved to be indispensable inputs into the formulation of the framework outlined in this paper.[8] As well as drawing on the work of the Basle Committee, the framework proposed in this paper has been developed in close consultation with the World Bank. The role of the World Bank in this area will complement and underpin the surveillance-oriented work of the Fund, in that its focus will fall on the microeconomic aspects of financial systems.

8. Although this paper describes in some detail the staff's distillation of widely-accepted views on what constitutes such a framework for a sound and effective banking system, few, if any, of the Fund's members have banking systems that possess all of these characteristics. The guidance provided here is mainly intended to assist in maintaining the soundness of relatively large and complex banking organizations specifically those that are internationally active.

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[7]See, for example, IOSCO Principles and Recommendations for the Regulation and Supervision of Securities Markets (Annex II), the International Accounting Standards Committee's Standards, numbers 30 and 32 (Annex III), and its discussion paper *Accounting for Financial Assets and Financial Liabilities* (March 1977), and the Group of Thirty's papers entitled, *Global Institutions, National Supervision and Systemic Risk* and *Derivatives: Practices and Principles.*

[8]The *Core Principles for Effective Banking Supervision* developed by a working group consisting of representatives of the Basle Committee and emerging market countries and issued for public comments on 4/7/97, has been a particularly important input.

While some of the principles are applicable to all banks, a simpler structure may be sufficient for smaller and less complex institutions. The focus in this paper is on institutions that have the potential to create systemic problems domestically or internationally.

9. Furthermore, some countries have in place an effective framework for a sound banking system that differs from what is described here. Nevertheless, the paper can be seen both as providing guidance for the direction in which supervisory structures and financial system reforms should progress, and as indicating some measure of the policy challenges that lie ahead. As noted earlier, the focus is on the banking system, the main financial intermediary in most Fund member countries, although there are also nonbank financial intermediaries and other elements in the financial infrastructure that make important contributions to the soundness of the system as a whole.[9]

10. As emphasized in Chapter II, Section A below, neither external market discipline nor supervisors alone can assure a safe and sound banking system. It is the appropriate combination of the two elements that encourage the competent and effective management that leads to a sound banking system. Alternatively, when managers have sufficient incentives, buttressed by market discipline, supervisors can use a lighter hand. It should be noted, however, that in many countries management needs external guidance, yet supervisors face political interference and have insufficient resources. Moreover, markets are embryonic. Thus, improvements are required in all relevant areas.

11. These principles and practices have been drawn from a wide spectrum of sources. The work of the Basle Committee on Banking Supervision on prudential standards as compiled in the *Core Principles,* has been an important source. In addition, the technical assistance work of the Fund and the World Bank has yielded a wealth of insights into what constitutes sound banking.[10] Furthermore, the experiences of supervisory agencies in some of the major industrial and emerging market countries have been useful in identifying principles and best practices.

12. Chapter I describes the role of the Fund in promoting financial stability as part of the ongoing broader international effort to achieve greater soundness in the financial systems of

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[9]They include interbank payments and settlement systems, legal processes for the making and enforcing of contracts and the transfer of property, including the taking and perfecting of security for loans, and the workings of the judicial system so that banks have access to speedy and effective legal remedies. On payments systems see, for example, *The Reform of the Wholesale Payment Systems and its Impact on Financial Markets,* Folkerts-Landau, D., et al., G-30 Occasional Paper.

[10] The Bank Supervision Guidelines issued by the World Bank and based on its extensive experience in advising countries on regulatory issues, also have been an important influence on the development of best practices for prudential supervision in emerging markets.

Member countries. Chapter II describes the key aspects of the framework for a sound financial system discussed in more detail in subsequent chapters, that is, transparency of the financial system, public sector guarantees, prudential regulation, supervisory oversight, and supervision of cross-border banking.

13. Chapter III examines the inherent difficulties encountered in compiling **reliable and timely banking information**. Best practices for the reporting of information to supervisors and for the disclosure of information to the public are described. Chapter IV examines ways to limit the adverse impact on incentives that can arise when public sector guarantees and other official commitments are extended to bank depositors, creditors, and owners. There is a general consensus that **safety nets** need to be designed to work without unduly distorting the risk-taking behavior of bank stakeholders. The design of the components of a financial safety net—lender of last resort and deposit insurance arrangements—is discussed. The chapter suggests principles for the use of a **strong exit policy** for insolvent banks as a means to limit the extent of official guarantees and undertakings. Chapter V presents a framework for **prudential regulation** based on the premise that regulatory restrictions on the activities of banks are needed to counteract the adverse incentives for risk-taking created by public sector commitments. The chapter discusses licensing policy, various qualitative requirements to strengthen governance, and the design and structure of quantitative prudential regulations.

14. Chapter VI presents principles and practices of prudential **banking supervision**. The focus is on the autonomy, authority, and capacity of the supervisor. The interaction of the bank supervisory authority with other supervisory and legal enforcement bodies are examined. The chapter also discusses practices of off-site monitoring and on-site inspection, and corrective and punitive measures available to the supervisor. Finally, Chapter VII examines issues related to the **supervision of cross-border banking.** The focus is on the modalities of supervising the international activities of banks and on international coordination and cooperation in developing banking supervisory standards. The topics covered in this chapter include the location of licensing and lead supervisory authorities, the licensing of internationally active banks, cross-border exchanges of information, inspections, and sanctions.

I. Role of the IMF in Promoting Financial Stability

A. Role in Promoting Macro Stability

15. The thrust of policy efforts to strengthen financial sector performance has to originate with national authorities. But the Fund and the international community at large have an important stake in the success of these efforts, because banking crises have macroeconomic consequences and may generate significant regional and international spillovers. As more countries remove remaining restrictions on their capital account transactions, and as banking

and finance assumes a more regional and international dimension, the cross-border impact of banking system problems can be expected to increase as well. These considerations have motivated broad international interest to contribute to the effort to achieve greater stability in banking and financial systems around the world, culminating in the statement by G-7 Heads of Government in Denver. The Fund's efforts to support the initiatives of many of its members to strengthen their financial system policies through its surveillance, lending, and technical assistance activities should be seen as part of this larger international effort now underway, and the Fund's work will have to be in concert with the endeavors of this broader international initiative.

16. The Fund's main instruments for promoting financial sector soundness are bilateral and multilateral surveillance, conditional lending, and technical assistance. In its **bilateral surveillance** activities, the Fund seeks to improve the macroeconomic environment and policies through a regular dialogue with the authorities of member countries and through discussions by the Executive Board of the staff's appraisal of macroeconomic performance and policies. Since a stable macroeconomic environment and a sustainable external position is a necessary condition for a sound and effective financial system, this effort contributes significantly to the stability of the financial sector. At the same time, as a sound banking system contributes to macroeconomic stability, a focus on banking sector issues is also appropriate for the assessment of macroeconomic and balance of payments policy.

17. By extending its analysis of the banking system, and, where necessary, broader financial system issues, the Fund's bilateral surveillance effort will also make a contribution to the wider international efforts to achieve greater stability in banking systems. The framework suggested here is, inter alia, meant to provide the Fund's staff with a broad guide for analyzing banking system issues by identifying key areas of vulnerability. Furthermore, the framework could be helpful in defining areas where corrective policies are called for, and it could provide guidance for policy discussions with authorities. Use of a framework, such as that outlined here, could help to make the analysis and policy discussions more consistent and transparent across a wide spectrum of the Fund's membership—although the focus on financial sector issues will need to be selective and due regard will have to be paid to the circumstances of individual countries. The increased focus of the Fund's surveillance on the financial sector will necessarily have to identify problems that are of potential macroeconomic concern. There is a need to develop soundness indicators for the key prudential areas discussed in this framework, in order to complement the relevant macroeconomic indicators.

18. The framework is to provide a broad basis for staff to consider a range of issues that may be important, particularly in helping to identify circumstances where a preliminary assessment may suggest potential benefits from further exploration. In the end, however, Fund surveillance will not be able to certify financial systems as "sound," or even reliably identify all instances where difficulties in the financial sector may become a major macroeconomic concern. Rather, the objective must be to increase the awareness of financial sector problems, their potential consequences, and their appropriate solutions in selective instances where they

may become a major concern. In this regard, as mentioned above, the framework suggested in this paper is clearly not a check list of issues to be explored in every Article IV consultation, neither is it a diagnostic tool that could allow an assessment of the financial position of individual banking systems.

19. In its **multilateral financial surveillance exercise**, which is considered by the Executive Board in its discussion of the International Capital Markets Report, the Fund assesses systemic developments and risks in the global financial system. Such multilateral surveillance also seeks to identify financial problems and risks that have a potential for spilling over regionally or internationally. In considering banking system developments in systemically significant countries, these surveillance activities could also benefit from the consistent application of a framework for sound banking, such as the one suggested in this paper.

20. In addition to increased surveillance, efforts to strengthen banking systems and to deal with outright banking problems or crisis have become a regular feature of **Fund supported adjustment programs** in some countries. The Fund has often assisted in identifying and diagnosing banking system problems; in helping design strategies for systemic reforms and bank restructuring; and in ensuring that such strategies are consistent with, and supported by, appropriate macroeconomic policies. In several instances, a Fund-supported program has been contingent on major banking sector reforms or systemic bank restructuring. Such programs have at times been coordinated with loans from the World Bank and regional development banks in support of financial sector reforms or individual or systemic bank restructuring.

21. Furthermore, Fund **technical assistance** has helped to strengthen the financial infrastructure of many countries through advice on basic central bank and banking legislation; on improvements in monetary and fiscal management; on foreign exchange, money and government debt market development; improvements in monetary statistics; the design of payment systems and deposit insurance arrangements; the development of prudential regulations and supervisory capabilities, and in particular the entry and exit of banks; and on strategies for systemic crisis management and bank restructuring. These efforts have been aimed mainly at developing countries and economies in transition, but have also involved a significant number of other member countries.

B. Role in Disseminating and Adapting Best Practices

22. An indispensable ingredient in the international efforts has been the work of the various multilateral official and industry groupings to compile principles, best practices, and guidelines covering the relevant financial activities or arrangements. Furthermore, the experience gained in some of the major industrial countries in formulating and implementing guidelines, standards, and best practices for use in the financial sector can be helpful to the relevant national authorities in a wider spectrum of the Fund's members, and can contribute to

the harmonization of rules and practices internationally.[11] The most successful of these initiatives has been the work of the Basle Committee on Banking Supervision, which has, inter alia, agreed on standards for capital adequacy and cross-border supervision of internationally active banks from the G-10 countries. These standards have now been successfully adopted (and in some cases adapted) by many emerging market countries, and in numerous other countries as well, at least in form, if not always in substance. In cooperation with supervisors from emerging markets, the Basle Committee's *Core Principles for Effective Banking Supervision,* are expected to be endorsed by a wide spectrum of non G-10 countries. Regional groups of bank supervisors, supported by the Basle Committee, have been active in promoting harmonization and improvements in regulatory and supervisory practices and are expected to support that process. Furthermore, IOSCO is working on similar standards for the securities industry, and there are incipient efforts by IAIS for the insurance industry as well. In addition, the International Accounting Standards Committee is developing standards, that are expected to be ready for international endorsement in March 1998. The standards, guidelines, or best practices being produced by these various expert groupings are crystallizing the experience gained over the past decade with formulating solutions to a wide array of problems in the financial system.

23. An increased focus on banking and financial sector issues by the Fund will contribute to the dissemination of best practices and will thus over time contribute to a harmonization of financial policies and practices internationally. At the same time, country experiences, as well as changing market conditions and other circumstances, will require that the framework suggested in this paper undergo regular revision. The experience that the Fund is gaining in its surveillance and technical assistance work can usefully be shared with the various expert groups. This suggests that cooperation and consultation between Fund staff and these groups are mutually beneficial.

C. Synergy Between the Two Roles

24. There is undisputed evidence that banking sector problems can be costly and disruptive to macroeconomic performance, and that the impact of such problems can make itself felt extensively across national borders. While national authorities have the primary responsibility for addressing banking problems, a concerted international effort, involving international financial institutions and expert groupings, is underway to reduce the incidence and the cost of such problems.

25. The near-universal membership of the Fund and its mandate to promote macroeconomic and exchange stability suggest that the Fund is well placed to contribute to a strengthening of the financial systems in its members by enhancing its surveillance to cover developments in their banking systems, particularly where they exhibit problems with potential

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[11] See Morris Goldstein, *The Case for an International Banking Standard*, International Institute of Economics, August 1996.

for generating serious macroeconomic disturbances. The continuous nature of the surveillance process is well suited to monitor and support the sustained efforts required by national authorities to improve the soundness and the stability of banking systems in member countries. The conditionality applied to the use of the Fund's resources can be, and indeed has been, used to ensure that weaknesses in members' banking systems are dealt with in a timely and effective fashion. Finally the Fund's extensive program of technical assistance can be used to ensure that member countries, in the process of liberalizing their banking systems, learn from the experience of others.

26. In order for the Fund's coverage of banking systems in its member countries to be as effective, consistent and transparent as possible, it is desirable to have a framework of general principles of sound banking that can assist in the analysis and assessment of the performance of banking systems across the wide spectrum of the Fund's membership.

27. In arriving at an initial outline of such a framework, the Fund has drawn to the maximum extent possible on the ongoing work of various standard-setting international groupings. The efforts of the Fund to extend and strengthen its surveillance over the macroeconomic implications of the operation of banking systems builds on, and is consistent with, the work of these international groupings, and in particular on the work of the Basle Committee in the specific area of bank supervision. In turn, the Fund's growing experience with surveillance over banking system issues can be used as input into the work of these groupings, and it can help to adapt these standards and best practices to the varying circumstances of its wider membership.

II. Key Aspects of a Framework for a Sound Financial System

28. While not the subject of this paper, it must always be remembered that **an unstable macroeconomic environment is a principal source of vulnerability in the financial system.** Significant swings in the performance of the real economy, volatile interest rates, exchange rates, asset prices, and inflation rates, make it difficult for banks to assess accurately the credit and market risks they incur. Moreover, banks in many developing and transition economies have limited scope to diversify these risks to the extent possible in industrial economies. Large and volatile international capital flows often add to the challenges faced by banks in these countries. While Fund surveillance will seek to improve the macroeconomic framework, a structural framework for sound banking should also attempt to assure that the macroeconomic risks are adequately reflected in prudential restraints and structural policies.

29. The second general source of vulnerability in the banking system, which is the focus of the framework for sound banking discussed in this paper, stems from weakness in the management of the banks themselves, and in the structural environment in which they operate. Such weakness together with a poor incentive structure lead, inter alia, to excessive risk-taking, and undermine corporate governance and market discipline—fundamental

ingredients for sound banking. For purposes of organizing the elements of a framework, five broad sets of challenges can be identified. First, **inadequate bank management** leads to undue risk-taking to the detriment of the interests of depositors and other creditors. Second, a **lack of adequate information on the financial condition of banks**—due in part to inadequate accounting standards and reporting and disclosure requirements, but principally due to insufficiently stringent rules and practices for loan valuation and loan loss provisioning—undermines the disciplining force of markets, and delays recognition of banking problems until well after the onset of difficulties, thereby making their resolution harder and costlier. Third, **the presence of implicit or explicit public sector guarantees of the liabilities of banks**—the official safety-net—in many cases has contributed to weakness in banking systems by encouraging excessive risk-taking by individual banks and weakening the discipline that would be imposed by depositors with money at risk. Forbearance in dealing with insolvent banks through a weak exit policy—in combination with generous support for depositors and extensive lender-of-last-resort assistance—frequently increases the ultimate costs of banking crises. Fourth, an **ineffective bank supervisory environment** frequently fails to counter the incentive problems created by the public sector safety-net and a lack of market discipline. Although most countries have elaborate regulatory systems, such systems often are not effectively implemented and enforced because of a lack of supervisory autonomy and capacity. Fifth, **concentrated bank ownership and connected lending may increase the vulnerability of banking systems**, particularly in developing countries. When banks are part of larger conglomerates, there is often a propensity for a significant portion of the lending of these banks to be directed to associated entities, making it difficult to evaluate the credit quality of loans and their collateral, and to measure the origin and quality of a bank's capital. In addition, state ownership of banks is frequently associated with inadequate governance, extensive guarantees of bank liabilities, and lax implementation of supervisory requirements.

A. Raising the Competence and Integrity of Management

30. The first line of defense against unsound banking is competent management. Most bank failures can be attributed to inadequate management that allows the bank to acquire low quality assets and take inappropriate risk positions, and that fails to detect and resolve deterioration in existing assets and risk positions. Quantitative regulation, although important, cannot ensure that a bank is well run. Bank managements need to possess a high degree of integrity, and have adequate training and experience to do the job. Sound management will ensure that good internal information and control systems are installed, for example to ensure that decisions affecting the rights and obligations of the bank never rest with just one individual (the "four eyes" principle). A sound bank will have prudent credit approval procedures, risk limitation and administration procedures, which are well documented, and appropriately delegate authority to the various levels of management.

31. Effective internal controls are necessary to ensure that established policies and procedures are followed and special interests are not allowed to influence decisions. The bank's board needs to have effective control over the management using internal and external

audit procedures to satisfy itself, the shareholders, and the supervisory authority that the management is discharging its functions competently and in the interests of the bank as a whole. The board should also ensure a proper relationship between the bank and its proprietors as well as with the supervisory authority, avoiding conflicts of interest among these entities.

B. Increasing the Transparency of Banking

32. It is inherently difficult to obtain a reliable assessment of the financial condition of banks, since most bank assets are illiquid and lack an objectively determined market value. The estimated current value of banks' loan portfolios should be reflected in the size of loan loss provisions, but bank managers are often unable or unwilling to arrive at a realistic measure of banks' impaired loan portfolios. The incentives for under-reporting or concealing data on bad loans grow as a bank's financial situation deteriorates. In addition, the growing internationalization of banks and the introduction of modern information technology by internationally active banks has enabled these institutions to rapidly move some of their risk positions into off-balance sheet or trust vehicles located on- and offshore. It has also become easier for banks to circumvent domestic prudential restraints on their risk exposures through the use of derivative products.[12] The ability of supervisors to monitor these activities has generally lagged behind the ability of banks to design new instruments.[13]

33. The opaqueness of banks' financial data is the Achilles-heel of effective corporate governance, market discipline, and official oversight in banking. External auditors and supervisors often fail to detect inflated loan values and inadequate provisioning. The monitoring of prudential ratios and restrictions on credit and market risk positions, including capital adequacy ratios, may thus become less effective as a means of detecting underlying problems. External auditors can play a useful role, and in some countries a major role, but only where the profession is significantly skilled and has a direct reporting responsibility to the supervisor. Elsewhere the only external agents generally in a position to assess with a significant degree of confidence the adequacy of banks' loan provisioning are the bank supervisors themselves. Arriving at such an assessment is one of the most important aspects of bank supervision, and one that requires competent supervisors with authority to overrule the valuations of banks and auditors. Misreporting of basic bank balance sheet data not only distorts prudential analysis, but also monetary and macroeconomic analysis. Furthermore, the lack of "hard" data tends to encourage supervisory forbearance, and makes the supervisory and judicial processes more vulnerable to political influences.

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[12]Although, when used prudently, derivatives enable banks to reduce their exposures and to manage risk better for the benefit of depositors as well as shareholders.

[13]See D. Folkerts-Landau and P. Garber, *International Derivative Markets and Financial System Soundness* (International Monetary Fund, Conference on Banking Soundness and Monetary Policy in a World of Global Capital Markets, January 1997).

Realistic Valuation of Bank Assets

34. Hence an important component of a framework for sound banking is that the system produces timely and reliable information for use by management, supervisors, and market participants. To this end, it is desirable to support the introduction of internationally recognized accounting standards, including a broad application of principles for consolidation of the operations of financial groups or conglomerates. Particular attention will need to be paid to loan classification, provisioning and income recognition rules, and to the practices for their effective implementation.[14] Accounting, valuation, provisioning and consolidation rules need to be complemented by proper procedures and practices for their effective implementation. Banks, therefore, need to have adequate internal reporting and control procedures and, in particular, appropriate credit approval, monitoring, classification and valuation, and recovery procedures.

Public disclosure

35. The more reliable and extensive the information that is disclosed by banks to the markets, the more effective is market discipline. However, the accuracy of public data on the performance of a bank often diminishes during times of stress; indeed, the integrity of financial data is likely to deteriorate precisely at the time when it would be most needed, i.e., when the bank is experiencing serious difficulties. Given these complications, best practices for disclosure in many countries typically go beyond disclosing traditional financial statements and provide other quantitative and qualitative information, such as the structure of the bank's ownership, risk concentration, details of policies and practices of risk-management systems.[15] Rating agencies can contribute to improving the transparency of banking data by demanding increased disclosure as a precondition for a rating.

Prudential reporting

36. Banks are required to report directly to supervisors, normally on the same basis as is disclosed to the public, but such reporting would include details of specific risks whose public disclosure would be unwelcome to individual customers as well as being market sensitive. It is generally acknowledged that supervisors should have the right to request all relevant data

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[14]Internationally agreed accounting practices special to banks have not yet obtained widespread official recognition. However, the International Accounting Standards Committee is developing such standards. Two of the standards particularly relevant to banks are attached (Annex III) and the Basle Committee has established a task force to contribute to the process.

[15]Chapter III discusses what information is made available in countries that follow International Accounting Standards and the most recent European Union and Eurocurrency Standing Committee recommendations.

from banks at reasonable notice. Supervisory reporting requirements, and associated off-site monitoring typically encompass both quantitative and qualitative bank-specific information that can be used to assess the risks banks face (including weaknesses in their loan portfolios) the ability of managers to control risks and the performance of the banking system as a whole. Qualitative information generally encompasses such items as credit policies, investment and trading strategies, the mechanisms of internal controls, the affiliations of major bank shareholders or senior management, and changes in corporate structure. Supervisors in the major financial centers increasingly focus on the adequacy of the internal risk-control capabilities of banks. Quantitative information typically includes data on balance sheet and off-balance sheet items, and reports on earnings, loan concentration, maturity and foreign exchange exposures. Not surprisingly, the greatest problems of reporting have been associated with loan valuation and (its mirror image) capital adequacy, and with off-shore activities.

C. Limiting Public Sector Distortions

37. If markets are to play an important role in disciplining bank managers and owners, there must be a presumption that financial assistance will not be provided automatically to troubled banks, and that owners and large creditors will not be fully protected. This suggests that, as a general principle, banks that are deemed to be insolvent by supervisors should be forced to exit in a timely manner, to prevent problems in individual banks from growing and contaminating other banks. Recent experience in a large number of Fund members suggests that public sector support for failing banking institutions is generally unduly broad. While the danger of precipitating a general loss of confidence has frequently made it difficult to close large banks without fully compensating most depositors, it is almost always possible to make the owners and large creditors bear a substantial part of the financial burden of losses. Such a prospect enhances the incentives for large and relatively well-informed creditors, including other banks, to exercise market discipline on weaker banks, not only because large creditors have more resources with which to monitor and influence individual banks, but also because they typically have access to better information than anyone else. **The broad goal for public sector policy is to leave enough room for markets to work sufficiently well, so that the banks' funding cost will appropriately reflect the quality of their balance sheets.**

38. In countries where directed lending and other quasi-fiscal operations involving banks, including different types of guarantees, conceal government subsidies and transfers, it is difficult for the government to deny support to these institutions when they run into difficulties. When such quasi-fiscal operations are being used, they are more effective when fiscal authorities transparently record and present the cost of such operations in the budget. Furthermore, if the tax regime is not to discourage prudent banking, banks must receive the benefit of a lower tax liability in making required loan loss provisions.[16] Moves to limit such quasi-fiscal operations and to reduce such adverse incentives introduced by the tax system can make an important contribution toward sounder banking.

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[16]See discussion of loan loss provisioning in Section III. A.

39. The framework of limited financial safety-nets and strict bank exit policy described below is applicable to individual banks in relatively sound banking systems. If the entire banking system is in distress it may not be possible to apply bank-specific principles, but instead system-wide restructuring strategies may well be needed.[17]

Lender of last resort facilities

40. The proper role of central bank Lender of Last Resort (LOLR) facilities,[18] is to provide promptly temporary support to illiquid but solvent institutions, typically at a penalty rate and against collateral, and to deny support to insolvent banks. Such lending can be an important instrument to prevent banking panics and runs, that could cause sound institutions to become illiquid and precipitate their insolvency. In practice, however, such lending has often supported insolvent banks—allowing them to stay in business and compete with solvent banks—thus undermining market discipline and the profitability of the banking system. Such behavior by central banks usually reflects concern about the danger of precipitating a crisis of confidence in the banking system that is already generally weak, often due in part to adverse macroeconomic conditions as well as weak bank management.[19] Also, the data problems discussed above make it difficult to distinguish illiquid but solvent from insolvent institutions. And, there is frequently hope that the institution will work its way out of trouble.

41. In order for a LOLR to operate effectively, without undermining market discipline, it needs to have sufficient information from the supervisory authority to determine which banks are approaching insolvency, so as to be able to limit support to sound but liquidity-constrained institutions, leaving the support of insolvent institutions to the fiscal authorities as soon as they can be identified.[20] This points again to the importance of good banking data.

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[17]See W. Alexander, L. Ebrill, J. Davis and C-J. Lindgren, *Systemic Bank Restructuring and Macroeconomic Policy,* (International Monetary Fund, forthcoming); and *Deposit Insurance and Crisis Management*, IMF Occasional Paper (forthcoming).

[18]Lender of last resort facilities for banks, when they exist, are typically provided by the central bank, as part of its role in assuring adequate liquidity in financial markets generally, but can also be provided by other public sector entities, such as state-owned banks, public sector enterprises and pension schemes (depositing funds in troubled banks).

[19]It is also noteworthy that banks typically become insolvent before becoming illiquid and the position of banks reporting near-insolvency often turns out to be much worse, once their true condition becomes apparent in the course of official intervention.

[20]If the government would like to provide solvency support for individual banks then this should be done in a transparent manner through the national budget.

Deposit insurance

42. Deposit insurance arrangements are designed to compensate some classes of depositors in case of individual bank failures. However, deposit insurance schemes are prone to problems of moral hazard and need to be designed to contain such problems.[21] Most effective schemes are therefore limited to protecting small depositors and do not cover large depositors and other creditors, including other banks, so as to create incentives for market discipline to exert pressure on banks. The breadth of insurance coverage, though, may vary depending on country-specific circumstances, but it would remain subject to the constraint of containing moral hazard.

43. A deposit insurance system needs to be well-funded so that it has the resources to pay off insured depositors promptly and allow the expeditious closure of insolvent members. As far as possible, the system should be self-financing. Insurance fees need to be high enough to cover the insurance cost of individual bank failures. Although it is desirable for fees to vary according to the estimated risk the insurance fund assumes, in practice it is difficult to arrive at an objective measure of risk that can be used for this purpose, and, therefore, uniform premia remain the most common form of pricing.

Exit policy

44. A credible exit policy for problem banks is necessary for effective deposit insurance and lender of last resort arrangements, and for the maintenance of a sound and competitive banking system. For exit to occur smoothly, it is necessary for the financial system to be sufficiently robust to limit the spillovers from the failing institution to the rest of the system. It is, therefore, desirable that banks be closed before they become deeply insolvent and cause major losses for their creditors. But even when these conditions are satisfied, the modalities of winding up a bank of significant size, whether through a merger, breakup, or closure, generally requires intervention by the supervisory authority, rather than simple application of the general bankruptcy statutes.

45. In order to reduce the scope for political pressure to prevent the exit of a bank, it may be helpful to limit supervisory discretion in favor of rule-based policies in the form of arrangements requiring prompt corrective action.[22] In this case the supervisory authority is required to force the bank to undertake remedial action well before it reaches the point of negative net worth. However, in order to be effective, a policy of prompt corrective action

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[21]See IMF Occasional Paper (forthcoming) *"Deposit Insurance: Best Practices and Country Experiences"*; see also G. Garcia, *"Deposit Insurance: Obtaining the Benefits and Avoiding the Pitfalls,"* IMF Working Paper No/96/83.

[22] For a detailed description of such schemes see Chapter IV.

requires timely and reliable information. In general, bank closures require a strong supportive legal framework, and rapid official intervention requires that supervisors have the authority to act outside the standard corporate bankruptcy procedures and without the need for political approval on a case-by-case basis.

D. Controlling Risk Through Regulatory and Supervisory Oversight

46. Regulation and supervision of banks seek to limit the adverse impact of the official safety-net on risk-taking and to force banks to internalize the externalities of failures.[23] The objective of such oversight should not be to guarantee the survival of every bank, but rather to make sure that the banking system as a whole remains sound. As discussed above, it is desirable that such oversight results in the exit of insolvent banks when market discipline fails. The supervision of individual banks is, of course, the responsibility of the national supervisory authority and is not an area which Fund surveillance would normally cover; nonetheless, there are cases when inadequacy in the supervisory approach can be a cause of system weakness with macroeconomic consequences, thus making it a legitimate case of inquiry. The best practices discussed in this section, and further detailed in Chapter VI, are largely based on the core principles for efficient banking supervision being developed by the Basle Committee in consultation with supervisors from emerging market economies.

Prudential regulation

47. Banking laws and prudential regulations seek to: (1) establish policies that allow only financially viable banks to operate; (2) limit excessive risk-taking by owners and managers of banks; (3) establish appropriate accounting, valuation and reporting rules; and (4) provide for corrective measures and restrictions on activities of weak institutions. Banking laws typically leave implementation to be defined by prudential regulations, in order to permit flexibility as circumstances change. The responsibility for promulgating regulations is normally vested in the supervisory authority.

48. Appropriate **entry policies** are essential for prudent banking and for healthy competition in the banking market. Financial sector liberalization often leads to calls for market entry, but an excessively lax entry policy often leads to banking problems at a later stage, particularly in cases where the capacity of bank management and domestic supervisors is inadequate. Licenses may be granted only when prudential criteria are met. But entry policy not only has to address prudential issues, it also has to pay due regard to the capacity of the

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[23] See for example remarks by Chairman Alan Greenspan at the meeting of the Institute of International Finance, Washington, April 29, 1997 "The presence of the safety net, which inevitably imparts a subsidy to banks, has created a disconnect between risk-taking by banks and banks' cost of capital. It is this disconnect that has made necessary a degree of supervision and regulation that would not be necessary without the existence of the safety net."

supervisory authority to execute its functions. It needs to strike a judicious balance between the objective of fostering competition (by encouraging entry) and maintaining supervisory effectiveness (by limiting entry).[24] This is best achieved if licencing is the responsibility of the supervisory authorities, and supervisors have authority to deny a license.[25] If a bank ceases to meet its licensing agreement, this then triggers corrective measures or becomes grounds for withdrawal of the license. Major changes in ownership or management also need to be subject to supervisory approval.

49. The **licensing process** attempts to ensure that a prospective banking enterprise will have suitably qualified owners, be properly organized, professionally managed, financially viable, and potentially profitable. The process is typically set out in the banking law, and *inter alia*, verifies whether: (1) the initial capital is sufficient; (2) the major shareholders and management are suitable for their offices; (3) the corporate structure is transparent; (4) the bank's organizational structure, including the quality of its administrative and internal control systems is adequate; and (5), in the case of a branch of a foreign bank, the bank is adequately supervised in its home country, and the establishment of the branch is approved by the home country supervisor.

50. **Capital adequacy** ratios (CAR) are viewed by the supervisory community as the most important restriction on banks' portfolio positions. The ratios are intended to ensure that banks maintain a minimum amount of own funds in relation to the risks they face, in order to absorb unexpected losses and give owners and managers an incentive to run banks safely. The most widely accepted method of measuring capital adequacy is the risk-weighted CAR promulgated by the Basle Committee (the *Basle Capital Accord*). Under this system, banks are required to hold different categories (tiers) of capital against assets and off-balance sheet items with different risk weights. This system was originally designed for internationally active G-10 banks, with good management and widely diversified risk portfolios. Supervisors in many other countries, where risk is more highly concentrated, management less experienced, and markets more volatile and less deep, and thus asset values more questionable, have concluded that ratios need to be considerably higher, and risk weights assigned to asset categories may need adjustment. Moreover, many international banks have found that to obtain the lowest funding rates, markets require a margin over the Basle minima. The Basle Committee has also developed an expanded system of CARs designed to incorporate market

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[24]Supervisors need, however, to beware of self-serving arguments by existing banks that more competition would endanger the system.

[25]The Basle Committee's *Core Principles* envisage the possibility of a separate body responsible for licensing in which case the supervisory authority must have the legal right to have its views considered by the licensing authority. In either case, the licensing criteria should be clear and objective and the process transparent.

risks (foreign exchange, commodity, interest rate and equity risk).[26] As mentioned above, effective measurement of capital adequacy requires proper valuation of banks' assets, and until this has been achieved, any analysis of capital adequacy ratios has to be undertaken with special caution. Moreover, CARs are often lagging indicators of banking problems and can be prone to manipulation through data problems.

51. **Limits on excessive risk taking** seek to promote prudent banking by constraining lending concentration, lending to insiders, liquidity mismatches, and net foreign asset (or liability) positions.[27] Needless to say, the enforcement of these limits requires reliable information on a consolidated basis in order to be fully effective. Limits on risk concentration take different forms, but irrespective of their form, such limits seek to restrict exposure to a single borrower or connected group of borrowers or counter-parties, to various sectors, and to market risk. Connected and insider lending to counter-parties that are related to a bank, such as directors, managers, dominant shareholders and their families, and lending to related corporate units, is best done on a non-preferential basis and be subject to tight limits, both individually and collectively.

52. Prudential **liquidity regulations** are imposed on banks in many countries to ensure that they are able to meet their creditor and depositor obligations without having to resort to forced asset sales or other costly means of raising funds.[28] Assuring that there is not an excessive concentration of funding sources or a significant maturity mismatch between assets and liabilities helps limit the risks in banks' liability positions. Frequently, liquidity requirements do not remain true to their intended purpose, and are used to create captive demand for short-term government obligations.

53. **Constraints on managerial actions** may restrict activities that have been associated with high-risk lending or investment activities that could expose banks to excessive risks. These constraints have been both restrictive and prescriptive, and apply in particular in cases where there are doubts that managers and owners continue to satisfy "fit and proper" criteria. Preferential treatment of insiders is restricted in order to minimize conflicts of interest.

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[26]The option that supervisors allow banks to use their own in-house risk management systems to calculate market risk-based capital requirements is so far applicable only to banks in major money centers with special expertise.

[27]Some supervisors prefer to exercise control by the imposition of capital requirements and by examination of the bank's own control systems rather than absolute limits. This applies particularly to liquidity and foreign exchange and other market risk positions.

[28] Although reserve requirements can also provide liquidity they exist primarily for monetary policy purposes.

Prescriptive rules have included requirements that managers put in place adequate risk management systems, including procedures for credit approval, monitoring, classification, and recovery, as well as for accounting, reporting and internal audit functions.

54. Prudential regulations normally define **accounting rules** for banks to use in compiling their reports on income and financial condition to ensure consistency. Most importantly, such rules establish how banks value and classify loans, make provisions for loan losses, and suspend the accrual of overdue interest. They include criteria for the treatment of loan rollovers, refinancing, and other forms of "evergreening" where management manipulates lending practices to make loans appear to be performing when they are not.[29] It is the responsibility of bank management to implement these rules, while it is the responsibility of supervisors to ascertain that banks have the policies and procedures in place to ensure that the rules are applied appropriately. Examiners have the authority to force banks to reclassify loans, require additional provisions, and reverse inappropriately accrued interest, where necessary.

55. The supervisor often specifies additional responsibilities for **external auditors**, has access to external auditors' reports and has the right to require the replacement of a bank's external auditors.[30] Such responsibilities in many cases oblige the external auditor to report material problems to the supervisor.

56. The supervisory agency is normally empowered by law to apply a range of **corrective and punitive measures**, when banks breach laws, prudential regulations or licensing agreements. Supervisors need to be able to tailor their responses to be commensurate with the offense and gradually intensify the corrective measures.

Prudential supervision

57. As part of their general duty to promote financial stability, banking supervisors monitor the soundness of the banking system, the adequacy of banks' risk management practices and financial data, and their compliance with prudential regulations. To be effective, a supervisory authority must have sufficient autonomy, authority, and capacity. Supervisory **autonomy**, of course, needs to be combined with legal accountability, and involves freedom from political influences and adequate financial resources to meet supervisory objectives.

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[29]In some developed markets such rules are left to banks and auditors to devise, and the supervisor's role is to ensure that the rules are prudent and that banks adhere to them. But in most countries, supervisors have felt the need to play a more active role.

[30]In many countries, where standards of bank auditing are not consistently high, supervisors maintain lists of approved auditors. Overt approval can, however, create an additional moral hazard for the supervisory authority if an approved auditor turns out to be deficient.

58. The autonomy issue is often linked with the **location** of the supervision function. In many countries the function is located in the central bank, sometimes with a separate board, while in some countries it is performed by an independent supervisory agency. There are arguments for and against locating the supervisory function in the central bank. On balance, at least in many emerging markets, the central bank appears to be the best location because it places the supervisor close to the central banks' other functions, such as lender of last resort, overseer of the payments system and collector of macro-financial data. Moreover, supervisors can avail themselves of the authority, financial independence, and expertise of the central bank.

59. An effective supervisory authority has sufficient **powers**, established by law, to carry out its functions, including powers to control the issue and withdrawal of bank licenses, request relevant data, conduct on-site examinations in a bank and any of its branches and subsidiaries, verify the data supplied by banks, call for loan provisions, restrain unsound practices, including issuing cease and desist orders and removing managers, denying or revoking licenses, and—where needed—forcing the exit of banks. In the absence of timely and reliable data, the authority of supervisors to use their own assessment of a bank's financial condition as a basis for corrective action is particularly important. Supervisory actions are often politically unpopular. Supervisors must, therefore, be able to act against banks without undue delays or pressures that result from a need for political approval or protracted court procedures.

60. Supervisors cover a range of increasingly sophisticated bank activities. They must not only verify banks' compliance with regulations and the accuracy of their reporting, they must also have the **capacity** to assess the suitability of the bank's owners and managers, adequacy of loan valuation procedures and the banks' net worth, internal controls and audit procedures of banks, (internal risk models, where applicable), and complex consolidated financial statements. In addition, they must be able to analyze relevant macro and market information, and take a view on behavior that may heighten systemic risk. To accomplish these increasingly demanding tasks, the supervisory authority should be able to attract and retain employees of high caliber, and to provide them with the necessary training, support, and appropriate remuneration.

61. Effective bank supervision must be seen by banks as a continuous presence. This is mainly achieved through **off-site monitoring**, both micro- and macro-prudential in scope. Micro-prudential monitoring is based on quantitative and qualitative information reported by banks, and consists of verification of compliance with laws and prudential regulations, analysis of prudential ratios and the individual bank's performance against peer groups and the entire industry. Macro-prudential analysis is based on market intelligence and macroeconomic information, and focuses on developments in important asset markets, other financial intermediaries, and macroeconomic developments and potential imbalances.

62. **On-site inspections** are needed to assess the adequacy of management and internal control procedures and to verify the accuracy of supervisory reporting. The latter is particularly important, given the potential weaknesses of loan valuation. While national practices differ, there are some common best practices. In particular, these practices call for all banks to be subject to some on-site inspection on a regular basis, and problem banks to be subject to particular scrutiny. It is desirable that inspections be comprehensive in scope and build on the inputs from the off-site monitoring. External auditors may play an important complementary role in banking oversight, but cannot replace supervisors. In some countries, on-site inspection is carried out by auditors acting under the specific instructions of the supervisory authority.[31]

E. Strengthening the Broader Structural Framework

63. The **structure and concentration of ownership** of the banking system may adversely affect the performance and stability of the system. Although there is a trend toward larger banks and financial conglomerates, such concentration increases the potential for systemic risk, which in turn increases the need for official oversight. Market perceptions that institutions are too big to fail will undermine market discipline and, therefore, require increased official supervision. Concentrated ownership has also meant that more focused political pressure can be exerted to obtain public sector guarantees for the liabilities of the bank. At the same time, in some developing countries the absence of a qualified controlling shareholder can result in ineffective oversight over management.

64. One of the issues relating to ownership concerns the desirability of state, private or foreign ownership of banks. The track record of **state-owned banks** (including banks owned by central, state and local governments) has frequently, albeit not universally, been poor. State-owned banks tend to bring competitive distortions to banking markets because they typically have access to low-cost capital and their liabilities tend to be fully guaranteed by the public sector. They are frequently exempted de jure or de facto from prudential requirements and have preferential access to deposits.[32] Nevertheless, there may be circumstances where state-owned banks can operate effectively, if they are required to operate according to commercial criteria and conform to the same prudential rules as private banks, and if they fully and transparently transfer all their quasi-fiscal undertakings to the government budget. Since these conditions are rarely met in emerging market countries, privatization may be the best solution to attain a sounder banking system.

[31] Unlike external auditors, these firms normally report to, and in some cases are appointed and paid by, the supervisory authority. For such an arrangement to substitute adequately for traditional examiners, a reliable, skilled and independent auditing profession is required.

[32] It should be noted that state-owned banks often are conduits for quasi-fiscal operations, which may then be used as justifications for forbearance from normal rules.

65. **Private ownership** in itself is no guarantee for good governance. There may be countries in which no suitable private owners are available, in which case the state may be called upon to provide banking services; in such cases normal prudential banking criteria are best applied. In some countries the lack of a capital market and the concentration of wealth is such that banking interests cannot be kept apart from other economic or political interests, frequently leading to conglomerates that include a deposit-taking institution. In such cases it is important that the bank is not used as a captive source of finance by their owners, other insiders, or related enterprises.

66. Efficient banking systems are open to **foreign ownership** (through branches, subsidiaries or partial ownerships), especially when there are only a few private domestic banks, to stimulate competition. Highly rated and adequately supervised foreign banks often bring necessary competition to inefficient domestic markets, and introduce professional skills and new technology, but perhaps most importantly, they typically reduce systemic risk because they tend not to be affected as readily by confidence problems as domestic institutions, and they are less likely to make claims on the official safety-net.

67. One problem that many countries face is the treatment of **non-bank financial intermediaries**. These fall into three categories. First, there are insurance, securities trading, and fund management businesses, which are normally regulated separately but increasingly are in common ownership with banks, giving rise to complex consolidated supervision problems. Second, there are finance companies, often owned by banks, sometimes created to avoid the full rigor of prudential, monetary, or tax regulations. Such institutions are often constrained by not being permitted to take deposits or use banking names, unless supervised as banks, but they may nevertheless depend on banks for funding and thereby create the potential for systemic risk. Finally, there are less reputable entities, and activities, such as the "pyramid" schemes seen recently in a number of countries and other forms of deposit taking outside the books of licensed financial institutions. Here, the need is for effective legal provisions to prevent the taking of deposits (or the use of banking names) by unauthorized entities or in unauthorized forms, together with a prosecuting authority which will respond to requests for action by the central bank and the supervisory authority.

68. Sound banking is facilitated by a strong **financial market infrastructure**, including an efficient payments system, money, as well as foreign exchange and capital, markets. In addition, the presence of institutional investors contributes to corporate governance. Payments systems need to be designed to limit the volume of unsecured overdrafts, as in real time gross settlement systems, so as to prevent spillovers across the payments system from the failure of a bank. The availability of efficient money and capital markets is important to allow banks to manage their liquidity, raise capital and issue debt; such markets are best designed with appropriate settlements systems and collateral practices to limit contagion risk. Efficient banking also requires a "credit culture"—an environment in which credit contracts are customarily honored and enforced, in the context of a legal and judicial system that facilitates

the enforcement of financial contracts, loan recovery, realization of collateral, and bankruptcy. In some countries, serious weaknesses in the judicial systems can negate improvements in corporate governance and official oversight.

F. Fostering National and International Supervisory Coordination

69. The various sectors of the financial system are prone to interact with the banking system in a number of ways and disturbances in one sector easily spill over into the banking system. In many countries, banks and other parts of the financial system (at times organized as financial groups or conglomerates) are typically regulated and supervised by different national authorities. It is, therefore, important that regulatory and supervisory **policies and practices be harmonized and coordinated**, as far as possible, in order to reduce the scope for contagion and regulatory arbitrage. The need for consolidated supervision of financial conglomerates has led to the practice in some countries of designating one national supervisory agency as the lead agency to coordinate the work of all supervisory agencies that relate to a particular conglomerate.[33]

70. Regulatory standards and supervisory practices are also being harmonized internationally.[34] This not only facilitates consolidated supervision and information sharing among supervisors internationally, it also improves efficiency and can bring important additional discipline to national regulatory and supervisory structures. It is increasingly needed in an environment of growing internationalization of banking that tends to undermine the effectiveness of nationally-focused prudential supervision in a variety of ways, including the use of complex corporate structures and offshore derivatives to evade domestic financial restrictions.

71. The Basle Committee on Banking Supervision has led efforts to improve cross-border banking supervision, starting with the 1975 *Basle Concordat* on the supervision of banks' foreign establishments. The Concordat divides supervisory responsibilities as follows. For branches of foreign banks, solvency supervision is primarily a matter for the parent authority. For subsidiaries, solvency supervision is a joint responsibility of both host and parent authorities. In both cases, liquidity supervision is primarily the responsibility of the host authority. For joint ventures, solvency as well as liquidity supervision should normally be the responsibility of the authorities of the country of incorporation. However, the key to effective supervision of foreign establishments, is close cooperation between the relevant supervisory

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[33]This was one of the suggestions included in the recommendations of the Tripartite Group of Securities, Banking and Insurance Regulators in "*The Supervision of Financial Conglomerates*" (Bank for International Settlements, Basle, July 1995), but it has not been universally accepted so far.

[34]For example, the Basle Committee and IOSCO have issued a Joint Statement in August 1996 detailing their coordination and cooperation.

authorities. In each case the bank and its affiliated institutions are to be supervised by the home supervisor on a consolidated basis. The Concordat was reinforced in 1992 by the following four "minimum standards": (1) all international banks or banking groups should be supervised by a home country authority that capably performs consolidated supervision; (2) the creation of a cross-border banking establishment should receive the prior consent of both the host and home country supervisory authority; (3) home country supervisors should possess the right to gather information for cross-border banking establishments; and (4) if any one of the foregoing minimum standards is not met to the satisfaction of the host-country supervisor, it could impose restrictions and prohibit the operation of the foreign banking establishment.[35]

III. QUALITY OF INFORMATION, SUPERVISORY REPORTING, AND PUBLIC DISCLOSURE

72. This chapter first discusses issues relating to the quality of financial data and difficulties in valuing bank assets. It then examines the types of information required by the various users of data describing the financial condition of banks. The adoption of internationally accepted accounting standards,[36] including the principles of accrual and consolidation would facilitate the production of high quality data. In addition, detailed rules governing the valuation of banks assets and the treatment of income and expenditure are often desirable. A by-product of good quality banking data is a more reliable input to the determination of macro-economic policy, but that subject is beyond the ambit of this paper. However, to the extent possible, co-ordination with compilers of monetary statistics will help reduce the burden on reporting entities. The focus here will be on the information needs of two types of recipients with an interest in bank soundness, supervisors and the public.

A. Quality of Banking Data

73. Reliable and comprehensive information on banks' financial condition is fundamental to effective corporate management, market discipline, and official oversight, and thus should be a very high priority. If such **information is not available**, management decisions may not be conducive to sound banking. Managers and owners (especially in cases where ownership is widely dispersed) may not be aware of the true financial condition of the institution or, if they are, they may wish to conceal it; the public may be misled and this may prevent market discipline from working. Moreover, lender-of-last-resort assistance may be misdirected in support of banks whose solvency is exaggerated. In addition, the absence of clear and unambiguous data may make it more difficult for supervisors to resist pressure to bend the

[35]See *"Minimum Standards for the Supervision of International Banking Groups and their Cross-Border Establishments,"* (Bank for International Settlements, Basle, July 1992).

[36]Such as those based on the recommendations of the International Accounting Standards Committee.

application of prudential rules and delay corrective action, in the hope that such banks may recover. Supervisors and courts are then liable to become more susceptible to political interference.

Accounting and valuation rules

74. Reliable estimates of the financial condition of a bank require well designed **accounting principles**. Such principles encompass the practices of accrual and consolidation. Particular attention needs to be paid to the use of valuation rules, e.g. historic cost, market prices, and estimated realizable values.[37] Accounting rules tend to vary from country to country, but most countries require their banks to value their principal assets—investments and loans to businesses, households and the government—in nominal terms (or according to some index); the value of performing assets can therefore be calculated relatively easily. However, once the capacity of the borrower to honor his debt is in doubt, or the loan contract has been breached and the loan has become nonperforming, the value of the asset becomes impaired.

75. In order to produce a reliable valuation for bank assets, one way would be to make an estimate of their market price. However, **reliable market pricing** mechanisms exist only in markets that are sufficiently deep, active and liquid—such markets exist only for certain types of assets, and only in a limited number of countries. Even when loans are legally negotiable, they are seldom traded and it is difficult to identify a clear market value. Thus, objective market based criteria for valuation of bank assets are frequently lacking, regardless of whether or not sound accounting techniques are used.

76. Consequently, there is always a degree of **uncertainty in the valuation of bank assets** and that uncertainty increases sharply during periods of economic distress or crisis. Asset valuation problems are often compounded by macroeconomic volatility or shocks, including high inflation or sharp disinflation, and large changes in exchange and interest rates. Valuation of bank loans, or investments in equity, or debt instruments, can be complicated by poor quality, or lack of, financial data on the bank's borrowers, doubts about the viability of their businesses, and the prospects for the sector in which the borrower operates. Banking information tends to deteriorate further when borrowers and bank managements have a mutual interest in masking the poor quality of loans in order to keep loans current, and thus avoid revealing losses and possibly losing control over their enterprises and the bank, respectively.

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[37]For an additional discussion, see Lindgren, Garcia and Saal, *Bank Soundness and Macroeconomic Policy* (Washington: International Monetary Fund, 1996), Appendix I.

Problems with bank asset valuation and income recognition[38]

77. A realistic valuation of assets and the prudent recognition of income and expense are critical factors in evaluating the financial condition and performance of banks. Since most banking assets are loans and advances, the **process of assessing the quality of bank credit** and its impact on the bank's financial condition is critical. Otherwise balance sheets may not reflect the true financial condition of the bank and the income statements may overstate profits upon which taxes and dividends are paid. Such an overstatement of profit is primarily due to the failure to establish realistic provisions for potential or actual losses, or to suspend interest on nonperforming assets often prompted by managers or proprietors' desire to enhance the standing of the bank and their income from it. When timely action is not taken to address problem assets, losses accumulate as opportunities to strengthen or collect these assets are lost and marketable collateral may dissipate. The losses may grow rapidly as bankers attempt to carry problem borrowers rather than recognize the losses and sever the relationship. If left unattended, such losses may threaten the solvency of the institution, and, if widespread, the banking system as a whole.

Loan portfolio review and classification

78. The starting point for any systematic assessment of banks' asset quality is a **loan portfolio review** conducted by the bank. Under normal circumstances, such a review covers all major customer relationships, including off-balance sheet commitments.[39] In addition, the review includes all non-performing loans, including those where there are concerns about the ability of the borrower to repay, as well as those that are past due. All loans to connected parties are also reviewed. A sample of the remaining portfolio is selected as it is important to check that loans classed as performing are in fact in order. Credit files and collateral documentation are reviewed on a case-by-case basis to permit an assessment of the borrower's repayment prospects, which depend mainly on cash flow and the business asset conversion or turnover. Collateral is normally viewed as a secondary source of repayment.

79. After a bank's asset portfolio has been reviewed, it is normally graded according to established criteria. A typical grading scheme used in many countries contains four grades of asset quality: standard or current, substandard, doubtful, and loss. The first category includes assets which are not considered problems. Assets falling into the latter three categories possess various degrees of well-defined credit weaknesses and are typically referred to as ***classified* assets**. In some countries, the criteria for classification are left to the judgement of individual banks, subject to an overall assessment by the supervisor. However, due to the

[38]This and subsequent sections draw heavily on Bank Supervision Guideline No. 6, from the "Bank Supervision Guidelines," Financial Policy and Systems Division, World Bank, 1992.

[39]Valuation of some types of contingent financial instruments may be difficult since they are often subject to complex pricing mechanisms.

weakness of the assessment process in many countries, the application of various rule-based criteria by the supervisory authorities themselves has been found useful. The evaluation of certain classes of high volume smaller loans such as mortgages, installment loans, credit card receivables, and hire purchase agreements may be based strictly on performance rules derived from historical experience, which can indicate the proportion of substandard assets that are likely to deteriorate into loss.

80. In case of **large borrowers**, sound policy would dictate that if a loan of such a borrower is classified in a bank, all other loans of the borrower in that bank should be similarly classified. This could be extended by the supervisor to apply to all other credits to that borrower from all other banks in the system, possibly through the presence of a central risk bureau.

Treatment of collateral

81. Credit decisions need to be based primarily on a detailed analysis of a borrower's ability to repay. In the absence of reliable financial information on customers, bankers in many countries typically rely on the collateral provided by the borrower. Over-reliance on collateral is problematic because the **collateral** is often illiquid, difficult to value during periods of financial distress, and costly (in terms of both time and money) to realize through foreclosure or other legal means. While collateral is a valuable protection against loss, it does not replace a careful assessment of the borrower's ability to repay. Collateral and other guarantees need to be appraised periodically, taking into account the financial position of the guarantor, legal documentation, and other factors.

Loan loss provisioning

82. Asset classification[40] of the type described above, together with a general reserve for the remainder of the portfolio (where specific risks have not been identified), provides a basis for determining an adequate level of **reserves for possible loan losses**. But other factors must also be considered, including the quality of banks' credit procedures, prior loss experience, loan growth, the quality and depth of management in the lending area, loan collection and recovery practices, and general trends in the economy.[41] There is considerable merit in

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[40]The process of asset classification is designed to encourage timely action on the part of a bank's management to strengthen or collect its problem assets.

[41]When observed loan loss experiences in a country deviate from those underlying suggested percentages from developed countries, such as the United States, required loss reserves may need to be appropriately adjusted.

estimating loss potential on a case-by-case basis, particularly for large borrowers, using provisioning rates based on observed loan loss experiences modified by judgmental estimates.[42]

83. Tax authorities normally accept that provisioning is a method for recognizing the loss in the value of a bank's assets. Specific provisions constitute a normal operating expense for a bank and should be **fully deductible from income for tax** purposes, provided banks consistently apply justifiable loan classification and provisioning rules. Not applying tax deductibility of provisions representing accrued losses, amounts to taxation of a loss and, therefore, by reducing after-tax retained earnings, would contribute to the decapitalization of a bank. However, when a bank chooses to apply an excessive provisioning percentage, it is not inappropriate for the tax authorities to decline to accept the higher provision as a charge against taxable income.[43]

Interest suspension

84. Another important aspect in evaluating asset quality is a bank's policy on the treatment of interest on problem assets. **Inappropriate income recognition policies** can rapidly distort banks' financial statements, especially when nominal interest rates are high. Failure, or even delay, in the payment of interest can seriously affect the value of the loan to the bank. Under accrual accounting, interest on performing assets is taken into income when it is earned. However, it would be inappropriate to count as income uncollected interest on loans which are seriously delinquent or where repayment of loan principal is in serious doubt, since the interest is not likely to be received. Where uncollected interest on nonperforming assets is included in income, the bank's profits will be overstated. The problem is compounded in cases where a bank is incurring economic losses but its management is not only reporting inflated accounting profits but also paying taxes and dividends based on those fictitious profits (to conceal the bank's true condition), thus causing a progressive decapitalization of the bank.

85. It is standard practice in such cases to **suspend the accrual of interest** in order to avoid overstatement of bank income and assets. When loans are classified any future recognition of interest income will only occur as interest is actually received in cash. Any interest that has previously been capitalized by an increase in the claim on a borrower, but not received, is regarded as doubtful and provided for, initially by a charge against current period

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[42]For additional information on loan loss accounting and provisioning in 14 OECD countries, and other more sophisticated approaches, see Beattie, Vivien, et al., "Banks and Bad Debts, Accounting for Loan Losses in International Banking," (Chichester: John Wiley and Sons, 1995).

[43] See W. Alexander, L. Ebrill, J. Davis and C-J. Lindgren, *Systemic Bank Restructuring and Macroeconomic Policy*, (International Monetary Fund, Forthcoming), Supplement 3, *Tax Treatment of Loan Losses of Banks*.

income. Any previously accrued income that has not been received, or capitalized, is reversed out of income to ensure that net income for the current period is not overstated. A bank, however, needs to continue to record the interest indebtedness of a borrower, to substantiate the total level of its claim in the event of liquidation of the borrower, or in the event that improved circumstances of the borrower permit full or partial recovery. For this reason, bank accounting systems may continue to record interest due but not received on non-accrual loans in one account but with a counterpart entry going to an offsetting *interest suspense* account. These accounts enable banks to track, and where required disclose, interest income foregone, as well as avoid overstatement of assets. In the absence of such accounting controls, supervisory monitoring can be difficult. Bank managers would have increased scope to "evergreen" loans. A typical approach is to require the suspension of interest on those assets which are, say, 90 days or more in arrears or are classified as doubtful or loss.[44]

Implementation issues

86. Because valuations of bank assets are prone to manipulation, especially when banks are in financial difficulties, most countries have introduced prudential **rules for the classification of impaired assets** and provisioning percentages on the lines described above. By applying consistent definitions, criteria and practices, owners, market agents, and supervisors alike can then analyze the financial condition of a bank. Needless to say, individual loan analysis may still be needed, especially for large credits.

87. It should be stressed that loan classification and provisioning is principally the **responsibility of bank management**, which must have in place appropriate accounting, reporting and control procedures for the appropriate monitoring and classification of all loans and collaterals, and the follow up of problem loans. Where minimum requirements for loan classification and provisioning are mandated by regulation, internal and external auditors verify that procedures are in place for compliance, and, if necessary, can call for additional provisioning.

88. Banks' loan loss provisioning and income recognition can be tested and **reconfirmed by banking supervisors**. An essential element in any system is the ability of the supervisors to overrule any provisioning made by banks. As discussed in Chapter VI, this requires that supervisors have the professional capacity to do such assessments and have the legal power and institutional authority to call for additional provisions or for reversal of income. Such action by supervisors could, of course, force a bank to disclose losses or even admit insolvency.

[44]For details see guideline 6 of the World Bank's *Bank Supervision Guidelines*.

International aspects

89. In order for international accounting standards to result in transparency of banking operations internationally, some **standardization** of loan loss provisioning and interest suspension rules is desirable. This is, however, an extraordinarily complicated area in which the international supervisory community, and even the EU, has failed to agree on common rules or guidelines for years. One regional group of banking supervisors, the Association of Banking Supervisory Organizations in Latin America and the Caribbean, agreed on a minimum set of such guidelines in 1991,[45] but these guidelines have not won wide acceptance in individual countries due to the lack of more widespread international consensus and a need for more specificity than they currently offer. The development of internationally accepted rules in these areas, possibly drawing on the World Bank's experience,[46] could make a valuable contribution to strengthening the quality of banking data globally. This, in turn, would directly affect the quality of monetary and other macro-economic statistics.

B. Information for Supervisors

90. The key ingredient in effective bank supervision is accurate and timely information about the financial status and operations of banks within their jurisdiction. This section discusses the **types of information** a bank supervisor might be expected to request and how they are best measured and collected. Not all countries will be able to meet all of these requirements, (at least in the early stages) but they indicate what supervisors need if they are to be in a position to assess the risks facing the banking systems they supervise. Moreover, in some cases the burden of providing information on relatively low risk activities may outweigh the benefit to the supervisor and distract valuable management time. But at least the supervisor needs to know where the significant risks are and have adequate information about them.

91. Bank supervisors should request information that enables them: (1) to assess the decision-making structures and competence of bank management; (2) to assess the risks undertaken by the bank; (3) to assess current and future profitability and earnings; (4) to determine the adequacy of capital, and (5) to monitor banks' liquidity.[47]

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[45]See *Proposal for the Classification of Credit Assets of Financial Intermediaries* promulgated by the regional organization and CEMLA, in 1991.

[46]See, for example, *Bank Supervision Guidelines*, World Bank, 1992.

[47] This is the basis of the framework, known as the CAMELS rating system, developed in the United States, and used in more or less modified form by supervisors worldwide. CAMELS refers to the evaluation of: Capital, Assets, Management, Earnings, Liquidity, and Sensitivity

(continued...)

Information to evaluate decision-making structures and management

92. While the effects of concentration of ownership of banks on the stability of banking systems is not well established, detailed information on **ownership structure** helps the supervisory authority to discern whether the bank is maintaining an arms-length relationship with its owners. An excessively close relationship has often resulted in weakened incentives for sound credit policies. The information typically shows the ownership structure of the bank,[48] and any cross-holdings in related institutions. In addition, if the bank is affiliated with other organizations, e.g. within a holding company or conglomerate structure, these affiliations are then transparent to the bank supervisor. Information is also provided on the foreign operations of domestically licensed banks and the local operations of foreign-owned or controlled banks.[49]

93. One of the most important duties of bank supervisors is to obtain information about banks' **management, directors and major shareholders** to assess whether they are "fit and proper" to carry out their respective functions,[50] in order to help redress the asymmetry of information in these areas between the bank and other market participants. The "fit and proper" test generally requires information about the identity, professional qualifications and experience, competence, honesty and integrity, and the personal financial status of the individuals. Such information will need to be verified by law enforcement agencies, court records, credit agencies, and interviews with previous business associates, etc. Information detailing business or personal relationships among directors, large shareholders, and counterparties of the bank is also collected to ensure both their suitability, and that any financial services provided to them or related counterparties are on a purely commercial basis.

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[47](...continued)
to market risk.

[48]For example, the European Union, "Directive on coordination of laws, regulations and administrative provisions related to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC," (89/646/EEC), Official Journal of the European Communities No. L 386/1, (Brussels: European Union, December 1989), requires that information about large shareholders is collected on shareholders holding 10 percent or more of capital or voting rights or who can exert comparable influence over the management.

[49]Issues in cross-border supervision are discussed in more detail in Chapter VII.

[50]For more details see Chapter V.A. and V.B. The "fit and proper" test is normally a licensing requirement but is also applied on a continuing basis, hence the need for supervisors to keep this information up to date.

94. Supervisors need to ensure that there is adequate documentation of the bank's **decision-making structures, business strategy, and operations.** This generally includes the terms of reference of senior managers, their relation to each other, and their respective authorities to commit the bank. Policies and procedures covering the decision-making processes need to be in writing and provided to the supervisory authority.

95. Well managed banks also maintain a fully documented business strategy and **operations policy manuals,** detailing the business objectives and procedures. Such documents are used by the internal and external auditors, as well as the supervisory authority to measure compliance with the bank's own strategies and procedures. The supervisor should also have access to full information about the internal control and internal audit systems, and all written audit reports, as well as all reports of the external auditors, including those provided to management but not to shareholders.[51]

96. The supervisor generally also seeks to ensure that the bank maintains an adequate **management information system** that permits accurate assessment and management of the risk position of the bank and accounts for all its claims and obligations. The reporting and recording should be consistent across various types of transactions and consistent accounting rules should be used for similar types of financial transactions.

Information to evaluate risks

97. The analysis of a bank's risk profile should include both **on- and off-balance sheet items** and their sensitivities to future events, with methods used for forecasting and managing their outcomes. Quantitative data for this analysis is usually submitted to the supervisory authority quarterly, but information on key areas where changes in risk exposure can take place rapidly, such as foreign exchange positions or interbank funding may be required on a more frequent basis.[52] On the other hand, most qualitative information is obtained annually or when there is a material change in its content. But it is important that bank supervisors should be able, at any time, to obtain any information that they consider important for their risk assessment of the bank. With the increase in various types of risk management techniques it is becoming increasingly important that supervisors understand the general risk management environment of a bank and not depend exclusively on numerical ratios.

98. Supervisors place high priority on accurate and timely information on the asset portfolio, paying particular attention to the procedures for valuing assets, classifying nonperforming loans, and provisioning. For most banks, **credit risk** is the most important risk, requiring the most careful analysis. Here the supervisory authority's primary role is to

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[51] The role of internal controls, internal audits, and external audits are discussed in Chapter V.B.

[52] Similarly, monetary data is normally reported at monthly intervals, if not more frequently.

ensure that banks are properly and adequately assessing ***their own*** credit exposures. Evaluating credit risk requires an understanding of the entire credit process. Hence, an essential element is the written **internal credit policy manual** describing credit conditions, authorization limits, credit diversification policies, procedures for approval, resolution of problem credits and credit administration.

99. Besides loans, other forms of credit exposure are becoming more common. For example, many banks have significant **off-balance sheet** commitments arising from such items as guarantees and other contingent lending agreements, where there is no claim currently on the balance sheet, but where the bank is committed to lend if certain circumstances materialize; very often they do so only when the borrower's ability to repay has diminished. These types of commitment are particularly susceptible to poor record keeping practices, as indeed are derivative contracts. Prudential reports need to indicate the likelihood of conversion into actual credit risk, as well as their collateralization. The credit risk in over-the-counter derivative contracts such as interest rate and foreign exchange swaps can be measured by the cost of replacing the contract should the counterparty fail.[53] In addition, other risks, need to be reported, such as the risk in the settlement of some foreign exchange operations, that, due to time-zone differences, the bank will pay out in one currency, while the counterparty may default before payment to the bank is made.[54] Thus, an analysis of a bank's overall credit risk exposure will typically extend well beyond the repayment risk inherent in the loan book, and will require increasingly sophisticated data processing techniques and systems.

100. Supervisors pay particular attention to **risk concentration, connected lending, and directed lending** as these are the areas where most banking problems originate. An evaluation of risk concentration requires information on the counterparties with the largest exposures, on-and off-balance sheet, claims on various economic sectors, industry groups or geographic areas.[55] Information on loans made to entities related through ownership, family ties, or other

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[53]Since credit losses are only incurred by the bank when it is worthwhile for the counterparty to default, only contracts that have positive replacement values to the bank need be recognized as a credit exposure.

[54] The settlement risk associated with differential timing of settlement of the two legs of a foreign currency transaction is called "Herstatt risk," after the failure, in 1974, of Bankhaus Herstatt, which was closed by its supervisors before delivery of U.S. dollars to counterparties could take place. See also *Settlement in Foreign Exchange Transactions*, March 1996, a report by the Committee on Payment and Settlement Systems.

[55]To promote international comparability, it is helpful to classify loans by sector and country in accordance with national accounts standards, such as those used in *System of National Accounts*, 1993.

links, as well as to large shareholders, non-executive directors, and senior management and their families are also reported in detail, specifying loan amounts, terms and approval procedures. Information on credits granted under government directed lending programs are usually reported separately where they are significant.

101. Information on **loan quality** is a key supervisory requirement. The supervisor is typically provided with an analysis of past-due loans by type of borrower, the payment capacity of selected borrowers, collateral, etc. As discussed above, this requires that the bank maintains a loan review procedure, and a loan classification and provisioning, and interest suspension system.[56]

102. While credit risk remains the most important risk, bank supervisors need to be cognizant of the **market risks** undertaken by the banks, and the sophistication with which these activities are managed, so that they may tailor reporting requirements to ensure that both they and bank managements can detect problem situations. The most important types of market risks are specified below. These risks have been separately identified for purposes of discussion, but in practice they are, to some extent at least, interdependent. In fact, one of the features of the Value-At-Risk approach (see Box 1) is that this interdependency is explicitly incorporated.

103. Virtually every bank operating in an environment of fluctuating interest rates is subject to **interest rate risk**, which arises as a result of the mismatch (or gap) between its interest-sensitive assets and liabilities. To measure this risk, banks and supervisors need reports on the maturity structure of the interest sensitive assets and liabilities, broken down into several daily, weekly, monthly or quarterly maturity "buckets". If off-balance sheet items are used to hedge the interest rate gap, a second report showing the position including the hedging instruments is necessary. Furthermore, since interest rate risk can be assumed in currencies other than the domestic currency, reports need to be provided for each currency in which the bank has a substantive position.

104. Interest rate risk may also affect the value of a bank's portfolio of interest bearing securities, where these are held in liquid marketable form. The bank supervisor requires information about the types of securities held, as well as a maturity breakdown for each type. Normally, such securities are reported at market values, regardless of whether they are intended to be held to maturity or for trading, but certainly for those in the trading book.[57]

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[56]Any loan that is not current or deemed to have a distinct possibility of loss is referred to as non-performing.

[57]The Basle Committee's "Core Principles for Effective Banking Supervision" consider that information used to monitor interest rate risk should distinguish between trading and nontrading activities, but do not advocate any particular accounting treatment. In the United
(continued...)

Box 1. Market Risk Measurement Systems

Risk measurement techniques used by commercial banks have evolved rapidly in many industrial countries, and the Basle Committee on Banking Supervision has agreed that banks, in certain defined circumstances, can use these techniques to calculate regulatory capital charges for market risk. In January 1996, the Committee recommended that national supervisory authorities permit banks to use their internal models for calculating a capital charge, provided that a set of qualitative conditions are met.[58] While the number of banks initially expected to be able to use the internal models option for regulatory market risk capital will be small, a growing number of banks are implementing sophisticated risk measurement techniques.

Most of the sophisticated models are variants of a Value-At-Risk (VAR) model, which attempts to measure the amount that would be lost with a specified probability over a predetermined holding period. So, for example, for only one percent of the time, for investments held over a ten-day time horizon, could the bank expect losses greater than "X" million dollars. When the VAR model covers a number of market risks, the risk-reducing qualities of portfolio diversification can be exploited to reduce capital requirements. Although VAR models may measure market risk more sensitively, they are costly: they are computer-intensive and require large, well-maintained data bases of price and position information. The output from such models does, however, depend on the assumptions made and on the validity of the historical data used. A VAR model should not be viewed as a *black box.*

In addition to VAR models, banks use stress-testing to provide them with a richer set of information about the risks in their portfolio of unusual events. A stress test may, for example, assume that some set of interest rates or exchange rates change by, say, five percent and calculate the potential gains or losses on the bank's portfolio. Within a stress-testing environment, the bank can choose the scenarios it views as most likely and obtain quantitative outcomes based on the specifics of their own portfolio. The market risk capital requirements of the Basle Committee recommend that banks have in place a "routine and rigorous" program of stress testing.[59]

The Basle proposals also permit banks the use of so-called Tier III capital. This form of capital, hitherto used by some US securities firms, includes short-term subordinated debt subject to a "lock-in" clause, which provides for it to be converted into equity if the firm falls short of its regulatory capital requirement.

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[57](...continued)
States, there is a movement to treat many liquid assets, even if intended to be held-to-maturity, as valued at market prices as suggested above. Moreover, International Accounting Standard 30 recommends that a bank discloses the market value of dealing securities and marketable investment securities if these values are different from the carrying amounts in the financial statements.

[58] The Basle Committee on Banking Supervision, "Amendment to the Basle Capital Accord to incorporate market risks," January 1996, p. 39.

[59] Ibid. p. 40.

105. A **sensitivity analysis** showing the gain or loss, by instrument, from a given percentage change in interest rate on the values of interest-sensitive items would also be extremely helpful. More sophisticated reports could show the effects of a change in slope of a yield curve, or other possible interest rate configurations. Regardless of the ability of the bank to perform sophisticated scenario analyses, management should always establish limits on the various instrument exposures incurred by the bank. Supervisors should assure themselves that such limits exist, are reasonable, and enforced.[60]

106. Bank supervisors need to obtain information about open positions in foreign currency in order to assess the **foreign exchange risk.**[61] As noted a maturity profile of the outstanding exchange rate contracts is also necessary since much foreign exchange risk may be undertaken or hedged through forward, futures, options or swap contracts.

107. Where banks are permitted to hold equity positions in corporate entities whose stock is quoted on major liquid markets, any significant **equity risk** is reported to the bank supervisor. At a minimum, the report normally provides a measure of total equity risk (the standard deviation in the equity returns over some previous period) or measure of the potential returns due to movements in the overall equity market of which the security is a part. **Commodity risks** based on changing commodity prices may also be present. If so, a report analyzing the impact of possible changes in value of commodity-based instruments, based on price changes in the underlying commodity, can also be provided to bank supervisors. Equity- and commodity-based risks depend to a considerable extent, on the phase of the business cycle and on whether asset prices are at historically high levels.

108. **Derivatives** are an increasingly common method of taking or laying off risks, at least by more sophisticated money center banks. It is essential for bank supervisors to understand how derivatives can be used for both hedging and position taking and to collect information on their use by banks.[62] Notional principal, or the principal amount on which various payments associated with the derivative are based, is the most commonly reported attribute of a derivatives contract. However, this quantity may be deceptive because it may be hedging other items on- or off-balance sheet. Both positive and negative replacement costs, that is the actual

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[60] These best practices are drawn from those recently proposed for discussion by the Basle Committee in "Principles for the Management of Interest Rate Risk," Basle, January 1997.

[61] Even when the bank itself has no net position, it may be exposed to risk if it has foreign currency claims on borrowers that do not have foreign currency earnings or if foreign currency assets meant to offset similarly denominated liabilities are in the domestic nontradeable sector.

[62] Some countries prohibit banks from using derivatives to speculate, but it is often difficult to distinguish between the risk-enhancing and risk-reducing characteristics of the contracts used in specific circumstances.

cost of replacing the contract at current market prices, better represent the exposure to market risks of the derivatives position. Exposures can be netted against other instruments to the same counterparty where netting is legally enforceable.[63]

109. The collection of notional principal amounts and replacement costs are no substitute for supervisors' overall understanding of the accounting rules in place in individual banks (as many banks adopt their own when there is a void in the traditional accounting treatment), valuation techniques, effects of leverage, and risk management techniques applied to derivatives.

110. Because derivatives can be based on a large number of underlying instruments (some financial, some not), their reporting needs to be broken down by the type of underlying market risk as well as the type of derivative instrument, in relatively broad categories, such as those suggested by the Eurocurrency Standing Committee for reporting requirements for dealer banks, e.g. interest rate, foreign exchange, equity and commodities-linked contracts.[64] The major derivative instrument classes consist of futures, forwards, swaps and options. Since options have limited losses when purchased, but unlimited potential losses when sold, the risks are particularly great.

111. Information on banks' **liquidity risk**, as well as holdings of so-called liquid assets, typically includes details of the bank's liquidity management methodology, indicating expected future cash flows and the liquidity gaps for specified future periods. An analysis of the liability side will also include information on the distribution, concentration, and types of funding sources, including interbank and central bank sources. On the asset side, banks report information about firm loan commitments, foreign exchange transactions, commitments to purchase securities, as well as expected shortfalls in cash flow, as a result of non-performing assets. Banks are often encouraged to undertake sensitivity analyses demonstrating the effects of changes in their future cash flows.[65]

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[63]Examples of disclosures meeting these recommendations are presented in Appendix B, Credit Risk Disclosure, of Euro-Currency Standing Committee "Public Disclosure of Market and Credit Risks by Financial Intermediaries," (Basle: Bank for International Settlements, September 1994), the "Fisher Report."

[64] See "Proposals for Improving Global Derivatives Market Statistics," Euro-currency Standing Committee of the central banks of the G-10 countries, July 1996, the "Yoshikuni Report," Annex 2 for the tabular form of the reporting framework used in the April 1995 survey of derivatives market activity.

[65]While the Basle Committee's "Core Principles for Effective Bank Supervision" do not explicitly require supervisors to collect the specific information recommended here, they state that supervisors should expect banks to manage their assets, liabilities, and off-balance sheet

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112. Some supervisory authorities collect information on a bank's ability to manage **operational risk**, that is the risk that business operations, from origination through execution and delivery, will fail to function properly. Such risks largely arise from failures of internal controls, although administrative and technical problems can also be responsible. Some of the most recent published bank problems, such as those of Barings and Daiwa, have been due in part to operational failures. As yet, there are no broadly accepted best practices in this area, but it is clear that the supervisor needs to ensure that the bank has well documented policies to avoid fraud, including procedures for the taking of disciplinary actions, and that its computer systems are adequately safeguarded against fraud, breakdown, and natural disaster.

Information to evaluate profitability

113. To assess the quantity and quality of earnings, and to gain insights on the ongoing viability of the bank, **income statements** provide information on the main sources of income and expenditure, including detailed information on the treatment of loan losses. While supervision is often focused on bank risks, it is equally important to evaluate the strength of banks' profits as this provides the basis for future capital generation, protection against short-term problems, and insight into banks' competitive position within the financial sector. Interest income and expenses are generally the most important categories in the income statement. However, non-interest income from service fees, investments, and trading often augments basic interest income. Details on non-interest income need to be identified, and its volatility assessed. Supervisors also watch for a dependence on volatile or inflation-related sources of income, as this can signal a higher risk profile and potential weakness. Any unusual or non-recurring income or expenses should also be noted. Information on operating expenses is also important, particularly in relation to a bank's peers.

Information to assess capital and capital adequacy

114. One of the most used indicators of bank soundness is capital, net worth or shareholders' equity. For the purposes of **calculating capital adequacy ratios**, capital is often divided into several components reflecting their availability to cover losses. Core capital, or shareholders' funds, represents funds that are free and unencumbered by any specific claim by creditors. Secondary, or supplementary, capital may include other items, including subordinated debt. The Basle Committee on Banking Supervision has formulated specific definitions of primary and secondary capital, referred to as Tier I and Tier II capital, for use in

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[65](...continued)
contracts so as to maintain adequate liquidity. See Chapter III, C, for supervisory recommendations.

its recommended minimum capital adequacy ratio.[66] Supervisors need to ensure that all components of capital are properly defined and accurately and separately reported. When data quality is poor, or the condition of the bank is deteriorating, the capital adequacy ratio will typically be a lagging indicator of the bank's condition. Even in good times capital will, of course, not prevent a bank from experiencing problems. But the more capital a bank has, the more scope it will have to deal with its problems

C. Information for Public Disclosure

115. The **public disclosure of information** about individual banks and the environment in which they operate is one of the most important methods of imposing market discipline. But the value of disclosure depends crucially on the reliability and accuracy of the available information. Without such information, it is difficult or impossible for the stakeholders to appropriately penalize bad management decision-making, for instance, by withdrawing funds, or selling the bank's securities, or to reward good decision-making.[67] In many cases market discipline can be most effectively exercised in financial markets by other intermediaries. For example, liquidity problems are likely to become apparent first when a bank is seen to be bidding aggressively for funds from its competitors. Public disclosure of its problems is likely to follow with a considerable lag.

116. In principle, the market, depositors, and the general public have no less a need for information than does the regulator. Indeed some countries such as New Zealand, are introducing systems that rely to a much greater extent on the public disclosure of information previously only available to the supervisor. Many others are now requiring greater disclosure in line with the general tendency for transparency in the business of all public companies.[68] For example, the once common practice of banks holding hidden reserves has now largely disappeared. Nonetheless, in practice there are in most countries significant differences in the information provided to supervisory authorities and that available to the general public. This is because much of the information provided to the supervisors is market sensitive or contains details about relationships with individual customers, and is provided by the banks on a confidential basis. In addition supervisors have available much qualitative information arising from bank examinations, and from regular and informal discussions with bank management.

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[66] See Chapter V.C, Box 6 for definitions of Tier I and Tier II capital and a discussion of the Basle capital adequacy ratio.

[67] However, for market discipline to operate market participants need to have sufficient alternative investment opportunities. If the banking sector or non-bank financial service sector is insufficiently large, and offers no reasonable alternatives, little reliance can be placed on market reactions to force management changes in banks.

[68] In Norway, for example, information on connected lending is routinely published.

117. Public disclosure is generally centered on the publication of **quantitative and qualitative information** in annual financial reports, supplemented by half yearly or quarterly financial statements. However, banks may release other information, such as proxy statements, quarterly earnings and dividend announcements, and press releases on recent or prospective developments. In addition, when banks issue debt or equity instruments, they need to prepare and publish a prospectus that satisfies the needs of potential investors. However, in many countries public disclosure is often "too little, too late", considerably reducing its value.

118. It is desirable that the information intended for public disclosure **meet the needs of all market participants,** including the bank's current and prospective shareholders and bondholders, other banks, depositors, borrowers, other creditors, other counterparties, and the general public. Financial market professionals, who are able to process highly sophisticated information and directly influence or correct bank behavior, may play a useful role in applying market discipline.[69,70]

119. Given the **sensitivity of banks' liquidity to negative public perception**, banks are always reluctant to provide information on poor results. The informational asymmetry between market participants and bank management is thus most acute when information is not positive. Such information, which has the strongest potential to trigger market reactions, is generally disclosed at the last moment, in the least reliable way. When such sensitive information is disclosed involuntarily, the markets' reaction can be very harsh.

120. Improved disclosure can be brought about directly by **law or regulation** or indirectly through **peer pressure** from powerful market parties. In some cases, the supervisor may have direct input into the rules governing public disclosure and, in many cases, there are special accounting principles applied to banks for the purposes of regulatory reporting. It is desirable for the same accounting principles to be used for public disclosure if at all possible. The direct approach involves mandating minimum disclosure requirements, such as requiring banks to publish specified portions of their prudential reports that do not reveal information that could be used by competitors to the banks' disadvantage. On the other hand, during normal times

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[69] This group includes rating agencies who often have access to additional information, in cases where they are permitted direct access to the banks they rate.

[70] Ideally, the information would be tailored to meet the specific needs of the various users, from the least sophisticated depositor to the most sophisticated investor. To satisfy this criterion, there need to be mechanisms that can process the raw information for the benefit of the various user categories. Institutional fund managers, rating agencies, and the financial press perform this function in sophisticated markets, but elsewhere there is often a sizable gap.

peer pressure might work by showing banks that disclosure is to their advantage in raising funds, e.g., if disclosure makes potential investors and depositors more likely to provide capital and deposits.[71]

121. Market discipline cannot be expected immediately and fully to take over the task of guiding banks' management, but its effect can be enhanced by **careful, progressive disclosure**, once the infrastructure is suitably developed. It is argued, justifiably, that sudden disclosure of negative information can damage the bank in question or the entire banking system disproportionately and unnecessarily. Thus, any new system of disclosure can best be carefully phased in during a period when banks are sound, and become a routine matter, thereby reducing the impact of negative information. Moreover, when accounting standards or disclosure methodologies do not yet provide readily accessible information and users are not yet sufficiently sophisticated to interpret the disclosed information, gradual introduction allows time to develop these aspects. This may thus prevent large quantities of sometimes poor-quality information from inundating inexperienced users.

122. The best practices for information disclosure outlined below contain the minimum information needed for a reasonable assessment of the risks and risk rewards for a bank.[72] Some of the practices suggest additional information to that which is generally available on the basis of statutory requirements. In fact, some argue that banks should **disclose all nonproprietary information** in their prudential returns. However, of primary importance is the disclosure of information permitting an accurate evaluation of the banks' risk profile, its profitability, and the capital available to support it. This can fit within the current structure of annual and quarterly financial reporting, with possible additional information provided contingent on certain events, for instance due to an increase in reserves, in anticipation of large expected losses, or an increase in nonperforming loans.

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[71]In this regard, a mixed approach would be to require that banks issue a specified amount of subordinated debt. Since the price of this debt would implicitly provide the market's assessment of the bank's credit rating, sound banks could benefit by increasing the amount and the quality of information they disclose, while unsound banks would be punished if they chose not to do so. However, this approach is only potentially useful if the country has relatively deep and liquid markets for such debt.

[72]The Basle Committee's "Core Principles for Effective Banking Supervision" do not elaborate the elements of public disclosure, as they are not often technically within the purview of banking supervision; however, as a precondition for effective banking supervision, they state that "effective market discipline depends on an adequate flow of information to market participants" and that such information should be "accurate, meaningful, transparent and timely".

123. Generally the centerpiece of public disclosure is the **annual report,** prepared on a consolidated basis, available to all market participants.[73] The format, typically laid down in statute, contains, in addition to a complete, audited set of financial statements, qualitative information, including for instance a discussion of management issues and the general strategy. It provides the names, other interests, and affiliations of the large shareholders and nonexecutive board members, as well as information on the corporate structure.[74] It makes clear what parts of the financial statements have been audited and what parts, particularly supplementary disclosures, have not. The financial statements also include information about off-balance sheet items, including some quantitative estimates of exposures to interest rate or exchange rate changes.[75]

Information on the condition of the bank[76]

124. Although financial disclosures of banks are the focus of this section, it is important to recognize that most existing rules for disclosure apply to other financial institutions as well. The EU's Bank Accounts directive,[77] for example, covers other financial institutions and most national laws or rules covering disclosure do so for all publicly-traded corporations. Thus, except for the attention to some specific items on a bank's balance sheet, the information needed to assess the risks and profitability of other financial institutions is the same.

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[73]The accounts of subsidiaries and other affiliates should, ideally, be prepared with the same year end and be audited by the same firm as the parent.

[74]This description, while not represented in the Basle Committee's "*Core Principle for Effective Banking Supervision*," is reproduced in several International Accounting Standards, notably IAS24, Related party Disclosures; IAS27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries; IAS28, Accounting for Investments in Associates; IAS31, Financial Reporting of Interests in Joint Ventures.

[75]In the EU, member states have been required to introduce a harmonized annual accounts format for banks, on the basis of the Council Directive of December 8th 1986 on the annual accounts and consolidated accounts of banks and other financial institutions (86/635/EEC); Official Journal 1986, L 372/1. See also IAS30, the accounting standard for banks and IAS32, dealing with the disclosure and presentation of financial instruments, produced by the International Accounting Standards Committee and included as Annex III, which have been adopted in a number of countries.

[76]The recommendations outlined in this section and the next, closely follow those recommended by the International Accounting Standards Committee in IAS30 and IAS32 and those of the Euro-Currency Standing Committee of the G-10 central banks.

[77]See "Directive on the annual accounts and consolidated accounts of banks and other financial institutions," (86/635/EEC), Official Journal of the European Communities.

125. The financial statements allow users to discern the **general risk profile and risk tolerance** of the bank, highlighting the areas in which the bank is taking on exposures, particularly credit risk. To allow a better understanding of the bank's risk tolerance, the report presents quantitative information on the risks and risk provisions, such as the maturity structure for interest-sensitive assets and liabilities, domestic and foreign currency liquid assets and liabilities, as well as a qualitative discussion of risk management and risk control practices.

126. Banks are normally also required to disclose information on **credit risk**, including risk concentrations by various broad categories, connected lending, and loans made under directed-lending programs. The user is able to obtain quantitative information on the relation between loans and total assets, nonperforming loans and loan loss reserves. Definitions for loan categorization, criteria for classifying loans as non-performing, and criteria for allocating reserves or provisions should be explained. The provision of information on write downs and recoveries of loan assets is also needed to obtain a full picture of the loan book. Other credit information includes **securities and off-balance sheet items** broken down by industry type and by credit rating (if rated), including a distinction between domestic and foreign entities. Information on traded instruments (including derivatives) normally includes the gross current losses that would be incurred if counterparties failed.

127. Disclosure of **liquidity risk** may be done through the balance sheet and associated notes on maturity structure of assets and liabilities, which enables users to distinguish between the amounts of more stable core deposits and the less stable purchased funds. This information also indicates which assets can be readily liquidated, as well as the level of off-balance sheet lending commitments.

128. As noted, best practices for disclosing **market risks** are still being developed. However, the intention is for a bank to report risks from a portfolio perspective whereby all the financial instruments related to the major categories of risk (exchange rate, interest rate, equity and commodity) are examined together, and financial derivatives should not be looked at in isolation from the rest of the balance sheet.[78] As with credit risk, a discussion of the

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[78]Recommendations for further improvements in public disclosure for financial derivatives activities can be found in "Public disclosure of the trading and derivatives activities of banks and securities firms" (Basle: Bank for International Settlements, November 1995) issued in conjunction with the Technical Committee of IOSCO. These recommendations encourage institutions to utilize the common minimum framework presented in the "Framework for supervisory information about the derivatives activities of banks and securities firms" (Basle: Bank of International Settlements, May 1995), also issued jointly with the Technical Committee of IOSCO, as this could improve the consistency and comparability of basic annual report disclosures. More recently, the Basle Committee and IOSCO's Technical Committee provided a "Survey of disclosures about trading and derivatives activities of banks and

(continued...)

methods of measurement and the philosophy undertaken in the bank to manage market risk should also be disclosed.

129. A bank ideally discloses **all material areas** of market risk. As a minimum, this should include a report on its interest rate-sensitive assets, liabilities and off-balance items by maturity. Depending on the risks in the bank's portfolio, the bank would also disclose foreign exchange exposure, broken down by major currency; equity or commodity risks, broken down by major category; and risks associated with its investments or its trading book, at a minimum disclosing the fair value (or market value), the carrying value, if different, and any unrealized profit or loss by security category.

130. If **derivatives** (or other instruments) are used for hedging, the bank also needs to explain the hedging techniques that it uses. Regardless of the techniques used, the bank should provide enough qualitative information so that the users can interpret the information disclosed. Such a description might specify the types of risks analyzed, the instruments covered and their use within the bank, and a brief description of the methodology.

Information on earnings

131. Information on earnings can provide important insights about the longer term prospects of a bank, enabling the user to determine the main sources of income and expenses and to calculate key indicators, such as earnings per share, return on average assets, efficiency ratios, etc. A breakdown of total income into interest and non-interest income, and a further breakdown of noninterest income may give insights into "quality" of the bank's sources of income and highlight volatile sources of revenue.

132. Similarly, expenses are generally broken down into interest expense (permitting users to calculate net interest income) and noninterest expense. To calculate net interest margins, the bank provides the amount of earning assets. Within the noninterest expenses, banks normally report employee compensation, incentives and benefits, as this is usually the largest category of expense, and any other material categories (for example, operations services, equipment, and occupancy). Specific reserves and provisions also need to be disclosed in the income statement.

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[78](...continued)
securities firms: (Basle: Bank of International Settlements, November 1996) to follow up the previous survey and update firms about the advances made since the issuance of the November 1995 report.

IV. PUBLIC SECTOR GUARANTEES

133. In almost all countries, financial safety nets are considered an integral part of the financial infrastructure and are seen as necessary for promoting the stability of financial systems by enhancing confidence in the banking system. Most **financial safety nets** have two key elements, namely, a lender-of-last resort (LOLR), usually the central bank, and a deposit insurance system (DIS).[79]

134. A major problem with any financial safety net is that it undermines market discipline. To counteract this effect it is necessary that **insolvent banks be allowed to fail**. Furthermore, the cost of failure should first be borne by the bank's owners/shareholders, at least to the extent of their investment, and then by the bank's larger creditors. Small depositors may be protected under a DIS, where one exists, although in the case of a systemic crisis, broader deposit guarantees may be offered. Furthermore, in an effective environment a failed bank's senior officers would be ousted.[80] A gradual phasing out of public sector support would help assist market forces to operate, but would need to be based on the development of the market and be instituted carefully and at an opportune time, as abrupt changes in public policies may have adverse effects; such changes would need to be accompanied by transparent public explanations of the new policy.

A. Components of Financial Safety Nets

Lender of Last Resort

135. LOLR policies typically have **three primary objectives**: (1) to protect the integrity of the payments system; (2) to avoid runs that spill over from bank to bank and develop into a

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[79]As neither a lender-of-last-resort (LOLR), nor a deposit insurance system (DIS) are under the formal purview of banking supervisors, the Basle Committee's "Core Principles for Effective Banking Supervision" are silent in these areas. Still, deposit insurance interacts with banking supervision; therefore, some basic principles are discussed in Appendix II of the Core Principles.

[80]If the failure was in part the result of incompetence or inappropriate behavior on the part of particular directors or managers, they may also be disciplined by being disqualified from operating in senior positions in bank management or on a bank board in the future. In addition, incompetent and dishonest managers could be subject to civil suits by bank depositors, creditors, and owners that have suffered loss, or be subject to criminal proceedings.

systemic crisis; and (3) to prevent illiquidity at an individual bank from unnecessarily leading to its insolvency. A central bank may also have a role in ensuring adequate liquidity in financial markets generally, but will also have a responsibility to ensure that its monetary policy objectives are not vitiated by its last resort lending.[81]

136. While central banks have a variety of tools that can be employed to achieve these objectives, three of these are most frequently employed. The first instrument is lending through the **discount window** to target aid to specific banks. The second and third tools, **open market operations** and **public announcements**, respectively, can be used to support the financial system as a whole. The relative importance of these tools varies across countries and according to circumstances, and their use can be influenced by such factors as the monetary policy stance of the central bank,[82] the financial system's institutional structures, and the country's exchange rate arrangements, as well as the degree of market segmentation and wide-spread weakness in the system.[83]

137. The very existence of a LOLR facility may weaken risk management incentives for banks, causing them to lend more than they otherwise might, and to maintain less liquidity than they would otherwise find appropriate. This tendency can be further exacerbated if LOLR support is available at a subsidized rate of interest. The **best practices** for central banks in **normal times** were laid out over a century ago, and have changed little since then. (See box 2.)[84] The key practice is for the central bank to lend only to solvent institutions and to be prepared to let insolvent institutions fail.

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[81]In some countries, there may be no commitment on the part of the central bank to act as LOLR or LOLR facilities may be provided by an entity other than the central bank. Since in most countries, the central bank has assumed this role, this section refers to the central bank.

[82]See, for example, Lindgren at al., *Bank Soundness and Macroeconomic Policy.*

[83]For example, in 1995 the currency board arrangement in Argentina limited the options available in response to the Mexican crisis. The authorities in some countries committed to fixed exchange rate regimes, therefore, are seeking innovative ways to overcome this problem. One way is to establish sources of external liquidity that can be tapped during crises, for example, through lines of credit granted by international banks.

[84]These were first laid out by Walter Bagehot, *Lombard Street: A Description of the Money Market* (New York: Scribner, Armstrong, 1873).

Box 2. Typical Practices for the LOLR in Normal Times

- Be available to the whole financial system;
- But only to solvent, although illiquid, institutions;
- Lend speedily;
- Lend only for the short-term;
- Lend only at a penalty rate;
- Lend only if the loan is collateralized;
- Accept collateral at a conservative value in normal times;
- Allow individual institutions to fail and be closed.

138. It is frequently **difficult to distinguish between illiquidity and insolvency**, even in normal periods. This problem can become all the more difficult when there are concerns that denying liquidity support may result in widespread confidence problems that may in turn have the potential to create a systemic crisis.[85] The globalization of banking and finance, the impact that the increased use of derivatives can have on bank liquidity, and growth in international capital flows make the demands on LOLR systems more difficult and complex to assess. In order to alleviate some of these problems, the LOLR needs to have access to relevant supervisory information, which necessitates close and continuous contacts with the supervisory authority.

139. To preserve the incentive structure and to prevent LOLR support from becoming long-term funding for the banks or to turn into a source of central bank losses, central banks would normally lend **short-term, with collateral valued at its pre-crisis price levels, and at a penalty rate**. However, even short-term collateralized lending needs to be conservative, since the condition of a failing bank frequently deteriorates rapidly. In such circumstances, continued LOLR support may allow an insolvent bank to accumulate further losses. Thus, while the LOLR is protected by the collateral it takes, the bank's other uninsured creditors may be made worse off as a result of the central bank's actions.

140. Central banks are also at times faced with the issue of whether to **support just the banking system or the whole financial system**. Some countries have adopted a policy of making the discount window available only to depository institutions (which, by their nature, are particularly vulnerable to runs). However, in some cases, the banks receiving central bank assistance are, in turn, expected and sometimes encouraged to pass on this benefit by acting as lenders of next-to-last resort to their solvent customers. Those that advocate that the LOLR should rely solely on open market operations, rather than lending to specific institutions through the discount window, argue that liquidity assistance to banks through open market

[85]These concerns are generally first raised by the bankers themselves, and they are often able to escalate concerns at the political level.

operations will filter through to the whole financial system.[86] However, such filtering may not occur in times of stress when confidence is low and the market becomes segmented. Many central banks therefore combine use of the discount window with open market operations.

141. **In times of systemic crises,** the central bank as LOLR attempts to assure the public that it will act firmly and limit the scope of any financial disturbance. While there are strong arguments for limiting such support to solvent institutions that need short-term liquidity, in a crisis, the need to reassure the public may mean it will be necessary to provide support to banks which turn out to be insolvent. But in many cases, such lending goes beyond the functions of a central bank and therefore needs to be guaranteed explicitly by the government. It is important for a central bank in this position to minimize, through, for example, offsetting open market operations, the impact on its long term goals for monetary policy.

142. In providing emergency liquidity assistance during crisis periods, central banks generally have sought to lend only on a short-term basis, but often without the penalty that they charge for liquidity assistance in normal times, since banks may be weakened due to problems that were not of their own making. When a major part of the banking system is insolvent, it is preferable that a comprehensive **bank restructuring plan** be designed and implemented, with new capital coming from the government and private sources, not the central bank, with any public costs recognized explicitly.[87] The government may decide that the central bank should provide support until a systemic restructuring strategy is in place, and perhaps thereafter; but such credit would normally be explicitly guaranteed by the government.

Deposit insurance

143. It is widely agreed that the primary objective of a system of deposit insurance is to provide a **safe asset to small savers,**[88] while avoiding the moral hazard that market discipline will be weakened. The protection of small depositors, while leaving large creditors at risk, will

[86] This argument is made by Marvin Goodfriend and Robert King, Financial Deregulation, Monetary Policy, and Central Banking," in William S. Haraf and Rose Kushmeider, eds., *Restructuring Banking and Financial Services in America* (Washington: American Enterprise Institute, 1988).

[87] See Alexander, Ebrill, Davis and Lindgren, *Systemic Bank Restructuring and Macroeconomic Policy,* (International Monetary Fund, Forthcoming)

[88] Generally, it is not cost-effective to expect the owners of small deposits to monitor the condition of their bank. As noted in paragraph 42 above, the extent of coverage may vary among countries.

increase household confidence, help protect the payments system, and thereby provide a measure of stability for the banks. These objectives as well as the basic structure of the DIS are conventionally defined in law and regulation.

144. Protecting deposits may also enable smaller and newly established banks to compete with larger, well-established banks that may be the beneficiaries of an implicit, "too big to fail" guarantee. Thus, it may help to counteract tendencies toward concentration in the banking industry, which in turn may make the banking system more competitive through the possibility of entry by new banks. While some countries have not yet enacted laws or regulations for resolving insolvent banks, the creation of a DIS makes it essential to have such instruments in place. Further, a formal DIS that offers limited coverage can reduce government outlays when political considerations would otherwise compel the authorities to protect all the depositors of failed banks. In most cases, banks meet the cost of the DIS in normal times.

145. It is desirable that the DIS be **sufficiently funded** to deal with incidental bank failures and that any disbursal of funds to depositors, should be executed without delay. Resources may be obtained *ex ante* by having banks contribute to a fund that accumulates to a target level or by imposing an *ex post* levy on surviving banks as the need arises. It is also often argued that a DIS should charge a "risk-based" premium, that corresponds to the degree of risk taken on by the bank, in order to ameliorate the adverse selection that accompanies a flat rate premium.[89] When a flat rate is charged, lower risk, well-managed banks are likely to subsidize the excesses of the higher risk, poorly managed banks, that are more likely to receive DIS assistance. However, measuring the risk profile and pricing risk is often difficult. All banks should be members of a deposit insurance system, since otherwise only the weak, high-risk banks will have the incentive to join, negating some of the efficiencies that arise from a broader risk sharing across banks.

146. It is rarely possible to ensure that depositors, especially large depositors, retain some incentive to monitor banks and that the banks in turn have incentives to maintain sound practices, unless **reliable information** about the extent of coverage, procedures governing the use of DIS funds, and the financial viability of the DIS is regularly and publicly disclosed. Some form of co-insurance, whereby the DIS pays only a percentage of the deposit insured or, perhaps, covers 100 percent of deposits to a certain, limited threshold, is advisable. Above this limit, leaving some risk with the depositor is also helpful. Since the existence of deposit insurance is often accompanied by some increased incentive to take on riskier activities, it requires strong and professional bank supervision to monitor banks' risk-taking activities.

[89]There have been very few attempts to introduce risk based premia mainly because such a system forces the authorities to be more open in identifying high risk banks. Nonetheless the concept has clear advantages.

147. A system of graduated, calibrated early intervention by the supervisory authority will help to restore problem banks to soundness or allow for their closure at minimal cost to the DIS, and with minimal damage to public confidence. Such a system would enable the DIS to **cope with the number of failures that occur in normal times** and even with most periods of multiple failures (see Box 3) through a combination of an existing fund and ex post assessments on all remaining banks.[90] However, a workable DIS cannot be expected to handle the costs of a systemic crisis involving pervasive failures. Once a widespread crisis is in progress, the government may deem it necessary to institute a full guarantee, either *de novo* or to override an existing scheme that has limited coverage, despite the moral hazard referred to above. However, it would normally only do so after other options have been rejected, the cost has been fully taken into account, and for a limited period.

Box 3. Typical Practices for a successful DIS Under Normal Conditions and in Systemic Crisis

In normal times:

- System should be explicitly defined in law and regulation;
- Resolve failed depository institutions promptly;
- Limitations on coverage;
- Wide membership;
- Deposits should be paid quickly;
- Adequate sources of funding to avoid insolvency;
- Risk-adjusted premiums (when risks can be accurately measured);
- Accurate information and disclosure of bank's financial condition;
- No decision-making authority for bankers within DIS;
- Prompt remedial actions;
- Close relations with LOLR and supervisor;

In a systemic crisis

- Extend coverage temporarily;
- Government backing for DIS.

[90] The DIS can be made even more resilient, and the costs of the scheme contained further, if the legal system gives the DIS priority over the assets of a failed bank. However, this means placing a greater financial burden on uninsured depositors and other creditors.

B. Exit Policy

148. Ensuring that banks approaching insolvency leave the market quickly and cleanly is one of the most important aspects of banking supervision policy.[91] An effectively implemented **exit policy** for weak and insolvent banks that demonstrates that banks will be allowed to fail is essential to counteract the adverse impact on risk-taking incentives created by even a well designed LOLR and DIS systems. It underscores market discipline by penalizing management, owners, and large creditors. Furthermore, such a policy limits the potential losses that might otherwise accrue to the public sector. While a central bank always needs to be aware of the danger that bank closure might trigger systemic problems, the earlier action is taken the less the impact on the rest of the system is likely to be.

149. An effective exit policy is not possible without an adequate and effective legal framework, and a supervisory authority that has the will, autonomy and powers to implement a firm policy. In countries where the supervisory authority is still in the process of developing sufficient independence, autonomy and skills, it may be difficult to withstand political pressures to exercise forbearance. Under those circumstances, it may be desirable to have rules providing for the use of obligatory graduated corrective measures, ultimately leading to mandatory closure.[92] When capital falls below a certain critical level, there is an incentive for management to try to assume more risk in the hope of benefitting from the higher return, hence there is frequently a strong likelihood that the bank will, upon closer scrutiny, prove to be insolvent. Early intervention therefore limits the damage to stakeholders in the bank. A **rule-based system** for intervention in banks can, however, increase the incentives for "window dressing" by bankers, and even bank supervisors, who could be reluctant to intervene, if such intervention were to trigger a mandatory response.

150. Rule based exit policies can be applied to individual banks. However, in distressed banking systems such a policy would not be viable as it could lead to a large number of more or less simultaneous bank closures. Under these circumstances, care must be taken that the necessary mechanism is in place to manage closures and recovery plans of undercapitalized but viable banks. Such a mechanism could be either inside the supervisory authority, or in a

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[91]The Basle Committee's "Core Principles for Effective Banking Supervision" acknowledge that prompt and orderly exit of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system and that supervisors should be responsible for, or assist in, orderly exit. The document does not discuss the potential benefits of rule-based exit policies for countries where the supervisory authority is weak, nor the specific modalities for an exit policy.

[92] In the United States for instance, the regulator is under a legal obligation to intervene in a bank when capital has fallen below 2 percent of assets. In practice many supervisory authorities would take some form of action well before that point.

separate body.[93] Once the independence, authority and quality of banking supervision have been enhanced, and the pressure to exercise forbearance has eased, a more discretionary system can be considered.

Conservatorship

151. When the problems in a bank threaten its viability, the imposition of **conservatorship** by the supervisory authority needs to be considered. Conservatorship can be described as the assumption of control, by or on behalf of the supervisory authorities, of a bank that is facing serious problems.[94] Under conservatorship it may be necessary to suspend the bank's obligations temporarily. Thus, time can be gained to assess whether the bank can be put back on track, while protecting the interests of the bank's creditors. The conservator establishes the bank's current net worth.[95] If viability seems possible, the conservator may manage the bank until new, qualified shareholders and management can be found. If not, the conservator will initiate liquidation proceedings. Experience in many countries shows that banks placed under conservatorship are rarely restored to profitability without major restructuring and injection of new capital. Ideally, a bank should therefore spend as little time as possible in conservatorship.

152. It is essential that the supervisory authority take action well before the bank fails. Once a bank starts to experience difficulties in its asset portfolio, its first tendency is to capitalize accrued interest, to underprovision, or to sell remaining good assets, in order to present an artificially high level of capital. During the decline of the bank's condition, the **risk of dissipation of assets** or looting rises rapidly. Therefore, the decision to impose conservatorship or close the bank needs to have immediate legal effect, notwithstanding possible appeals against such decisions. In the majority of cases, banks that have been placed under conservatorship or similar form of supervisory control, do in fact prove to be insolvent.

Closing a bank

153. Once it is clear that a bank cannot be restored to profitability, or the use of conservatorship is not feasible either due to a shortage of qualified persons or a lack of

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[93] Special arrangements may be required when intervening in and restructuring banks in cases of systemic banking problems, where the closure of many banks is undertaken. These issues are addressed in: W. Alexander, L. Ebrill, J. Davis and C-J. Lindgren, *Systemic Bank Restructuring and Macroeconomic Policy*, (International Monetary Fund, Forthcoming).

[94] Different countries use different terminologies. In some, such a person is called a receiver, in others a temporary administrator. In this paper the term conservator is used.

[95] Given the high level of business expertise required, the recruitment of suitable conservators may be difficult in developing or transition economies.

supervisory resources, its **license has to be withdrawn**, and the liquidation process initiated. The decision that a bank is to be liquidated can result from: (1) the supervisor's judgement that the bank is insolvent; (2) the violation of other licensing criteria; (3) missed interest payments or other financial obligations that spur creditors to file a bankruptcy suit; or (4) bank owners that voluntarily desire to close the bank. The first reason for liquidation is the most problematic. The closer a bank approaches insolvency, the stronger will be the incentives to hide information from the supervisory authorities and the markets. This makes it difficult for the supervisor to establish insolvency irrefutably, and makes the timing of the bank closure difficult. The supervisor risks taking corrective action too late, in which case it will be reproached for not taking timely measures, or it risks taking action at a time when the bank will be able to mount a plausible case that closure was unnecessarily imposed and caused material damage to shareholders. While in many countries the decision to liquidate is for the courts, as it affects the interests of creditors and shareholders, it is important that the supervisor has powers to initiate the process and to restrict the bank's business pending the court's decision.

154. When the bank is insolvent, the loss will need to be allocated among creditors. Most legislative systems have set priorities for the satisfaction of different categories of creditors. Where there is no deposit insurance system, priority settlement to household depositors is sometimes recognized. To ensure problems of moral hazard are kept in check, the primary brunt of the bank's failure needs to be born by the bank's shareholders. The technical **procedure for liquidation** is normally laid out in the law, and requires it to be performed by a professional liquidator. This function generally does not belong within the supervisory authority.

155. Because confidence in a bank can be terminally damaged by a bankruptcy suit brought by creditors, especially if the suit is unjustified, and because there is a need for speedy action, special insolvency procedures for banks are often established. The supervisory authorities may then be able to delay a decision on the bank's bankruptcy, while it investigates whether the bank is solvent or not.[96]

V. PRUDENTIAL REGULATION OF BANKING

156. Banking laws and prudential regulations need to define a framework that induces banks to operate in a safe and prudent manner, and the regulatory and supervisory framework needs to counteract the distortions introduced by public sector guarantees. This requires a consistent set of requirements governing accounting, asset valuation, supervisory reporting

[96] In case of voluntary liquidation, when shareholders wish to terminate their business, the supervisory authority should be able to control the liquidation process, in the interests of the bank's depositors and other creditors.

and public disclosure, risk taking and risk-management, and entry and exit. This chapter is divided into three parts, covering entry policy, governance and risk management, and quantitative tools of prudential supervision.[97]

A. Market Entry—Bank Licensing

157. During the initial establishment of a banking enterprise it is difficult for potential market participants to distinguish a potentially successful enterprise from one with a high probability of failure. This problem is due in large part to the **asymmetry of information** between the new management and owners and the potential investors, depositors, and others. Since a bank's viability depends critically on its ability to generate the confidence of depositors and other counterparties, the effects of asymmetric information are most acute during this initial stage. To help bridge this informational gap and create an environment where subsequent market discipline can operate, banks are subject to licensing requirements.

158. Sound licensing policies are essential, and the **licensing process** must be both thorough and independent. Because of the links between licensing requirements and the requirements for subsequent ongoing supervision, it is helpful if licensing and banking supervision are conducted by the same agency.[98] The supervisory authority needs to establish whether the prospective banking enterprise will be professionally managed and financially viable, so that it can filter out applicants that do not meet these criteria. Licensing requirements need to be clearly set out in the banking law, and require a rigorous assessment of management, owners, business plan and capitalization, which requires knowledge, experience, and judgement on the part of the supervisors. Licensing requirements need also to be objective and transparent to potential applicants and to the public.

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[97]Most of the regulatory practices described in this section of the paper have been developed by the Basle Committee.

[98]Although the Basle Committee's "Core Principles for Effective Banking Supervision" are silent on whether licencing and supervision should be conducted by the same institution, they do note that where they are different, close cooperation needs to be present and that the supervisory authority should have the legal right to have its views considered by the licensing authority.

Box 4. Initial Capital

In most countries, banks are at all times required to maintain a statutory minimum level of capital. Initial capital is intended to finance the initial business of the bank, and to provide the bank with working capital in its early stages of development, say, for a period of at least three years, after which a new bank could normally be expected to be earning profits. Should capital fall below this statutory minimum, the bank would no longer be in compliance with the licensing requirements, and would risk losing its license. In practice, therefore, it is important that banks start with a capital level higher than the absolute minimum, in order to be able to accommodate losses in the initial period of the bank's activities. It is important that shareholders finance the initial capital in cash, on the basis of their own net worth, not on the basis of borrowed funds. Such an obligation is designed to ensure that the promoters of the bank are seriously committed to its future viability. Experience in many countries has shown that banks are particularly vulnerable in their early years. Indeed failure rates are much higher for new banks than for old established institutions; capital ratios therefore also need to be higher in a bank's first years.

The level of minimum capital varies between countries. In the European Economic Area (EEA) a minimum of 5 million ECU is required. Other countries require considerably more. Banks need to be of a certain minimum size to be viable commercially and organizationally. In exceptional cases, for instance small rural banks, established for limited purposes, a minimum of less than US$1 million is sometimes allowed. It is important that statutory minimum capital be made up exclusively of paid in shareholders' funds.

159.
The licensing process is designed to ensure that:

- the quantity and quality of the initial capital are sufficient (see Box 4);[99]
- shareholders and the management of the bank are "fit and proper";
- the governance structure of the bank, and the structure of any group to which the bank belongs, is transparent and does not hinder effective supervision;
- administrative and internal control systems are adequate;
- the bank has an economic rationale, assessed on the basis of a business plan; and
- in the case of the establishment of a foreign bank: that the bank is adequately supervised in its home country.[100]

160. Banks need to be in compliance with the **licensing requirements** at all times and the supervisory authority must be able to withdraw a bank's license if any single licensing

[99]The Basle Committee's "Core Principles for Effective Banking Supervision" do not discuss minimum initial capital, but do suggest that supervisors should consider requiring higher than minimum capital ratios when it appears appropriate due to the particular risk profile or other characteristics of the bank, and further that no bank should be allowed to operate with ratios below the established minimum.

[100]See Chapter VII.B.

requirement ceases to be met. Material changes with regard to licensing requirements, for instance changes in management and ownership or substantial changes in the bank's operations relative to its approved business plan, therefore require the approval of the supervisory authority.

161. There also need to be arrangements to deal with financial **intermediation** that may take place **outside the licensed bank sector**. This requires powers, whether exercised by the supervisory authorities or not (but on which the supervisors can rely), to deal with the closing down and prosecuting of the perpetrators of illegal activity, e.g. through the unlicensed use of the word "bank" in business names, or the taking of deposits or otherwise soliciting funds from the public without a banking license. In the case of legitimate financial intermediation outside the banking system, e.g. through finance companies not owned by banks, there also need to be arrangements to monitor their activities and, where necessary to supervise them in such a way as not to promote regulatory arbitrage. Experience has shown that in many countries the activities of non-bank financial institutions can threaten the integrity of the financial sector as a whole.

Management, nonexecutive board members, shareholders

162. **Bank corporate structures** differ across countries. In most of them, full responsibility resides in a single board, comprising both the day-to-day executive management, and the non-executive oversight and advisory functions. In others, these functions are divided on the German model between a management board and a supervisory board. Good governance, particularly the appropriate exercise of the relationship between the shareholders and non-executive directors on the one hand, and day-to-day management on the other is the key to safe and sound banking.

163. Bank managements are required to be **fit and proper,** i.e., they should have integrity, be honest, competent, technically qualified and with an appropriate level of banking experience. It is becoming increasingly important for bank management to be highly trained and experienced, since given the growing complexity of the business, less than fully competent employees can cause problems with profound consequences. The track record of individuals applying for bank licenses and the managers they propose should, therefore, be carefully examined. The ultimate criterion is whether the way in which the bank is managed can retain the confidence of the markets and the public.

164. Supervisors have the power to **object to appointments** of all board members or members of separate supervisory boards. Since the tasks of non-executive board members are primarily to provide strategic advice and to oversee the actions of the management and not the day-to-day decision making, technical expertise carries less weight than for executive management. However, experience and probity should continue to be valued as highly as for management appointments. The supervisor, to the extent possible investigates non-executive

board members' other interests, and assesses the scope for conflict of interest with the bank's interests and those of its creditors.

165. The supervisory authority also has a right to **object to shareholders**, or groups of related shareholders. In case of doubt concerning the shareholders' reputation, or whether they will remain at arms' length from the bank, the supervisor would be able to refuse approval. The underlying criterion for evaluating shareholders is whether they will ensure that the bank is managed as a profitable institution responsible for its financial obligations, rather than for the personal benefit of a selected group of managers or shareholders.

166. The supervisor therefore needs to be as informed as possible of the ownership of significant proportions of the bank's shares. The **transfer or acquisition of significant holdings** must be conditional on the supervisor's consent. In addition, the beneficial ownership of significant holdings, and any form of concerted exercise of influence by persons individually holding shares in amounts below the threshold for approval, must be identifiable and subject to supervisory approval. In the absence of supervisory approval, any decisions taken as a result of influence exercised by unauthorized shareholders would be subject to being declared null and void.

167. When a license is sought by a **foreign bank**, the supervisory authorities of the home country must give explicit approval. The supervisory authority has a duty to approach the home authority for information on the organizers or shareholders.[101] Additional care needs to be taken when a licensing application is received from foreign individuals who have no connection with a supervised entity and where there is therefore no home authority to provide support.

168. When banks are part of a larger **group of corporations**, financial or non-financial, domestic or international, the governance of the bank can be influenced by entities that are themselves not subject to banking supervision (see Box 5). This can pose serious risks to the effective exercise of banking supervision. Similar problems can occur when a bank itself is not transparently structured. For example, in some countries, bank holding companies often own assets in the real sector as well as banks in other countries, both industrial and developing. In the context of the licensing process, the supervisory authority should not grant a license unless it is clear that the structure of the group does not hinder the exercise of effective banking supervision. For effective supervision it is important that each regulatory body involved in supervising different corporations within the group establishes contact with the other agencies involved, and be authorized to exchange information.

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[101] See Chapter VII.B.

Box 5. Conglomerates

Increasingly, banks form part of so-called financial conglomerates, defined as groups of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two financial sectors (banking, securities, insurance).[102] In many countries banks can also be part of groups with significant non-financial interests. While there are certain economic advantages to such relationships (such as economics of scale and scope), they raise a number of issues that are relevant to effective bank supervision. First, such structures entail the risk of "regulatory arbitrage," that is, the exploitation within the group of differing regulatory arrangements. Second, the bank's governance may be influenced by other corporations in the group that are not subject to banking or other financial supervision. Third, to assess the independent position of the bank, the supervisor needs to be able to obtain information on the structure of the group, and on financial flows and relationships within the group, as well as on the financial condition of other group entities. In this context, the question arises to what extent supervision on a consolidated basis is possible, in view of the position of the bank in the structure (parent or subsidiary) and the nature of the other activities of the group. If consolidation is not feasible, the bank supervisor will need to determine to what extent the risks in the rest of the group could affect the bank.

Special challenges must be faced when a financial conglomerate is active internationally. For effective supervision, full information is needed by each of the regulatory agencies in each of the countries involved, on the group as a whole as well as on its components. In case of problems, supervisory actions will need to be coordinated, internationally and between regulators for the different financial sectors. This can create considerable information coordination and legal problems. To minimize such problems, some countries have found it helpful to designate one national supervisory agency as a coordinator for such groups, at the domestic level, and to develop a framework for cooperation between domestic and other international supervisory agencies. Closer coordination of regulatory issues among bank, securities and insurance regulators on an international basis is currently being discussed by the Joint Forum[103].

Business plan

169. A bank requesting a license should be able to demonstrate that it is financially viable by providing a valid **business plan** setting out its strategy for the first three years. Such a plan would include the results of market analysis, marketing intentions, resources (including staff), the expected competition, and its expected profitability. The business plan must present the administrative and organizational structure of the bank, including internal controls and the

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[102] See *"The Supervision of Financial Conglomerates"* A Report by the Tripartite Group of Bank, Securities and Insurance Regulators (Basle: Bank of International Settlements, July 1995). Also see *"The Regulation of Domestic Financial Conglomerates"* by David Scott, Policy Research Working Paper 1329 (Washington: World Bank, August 1994)

[103]The Joint Forum on Financial Conglomerates was established to bring together representatives of the Basle Committee, the International Organization of Securities Commissions (IOSCO), and the International Association of Insurance Supervisors. Its mandate is to draw up proposals for improving co-operation and the exchange of information among these groups and work toward principles for the future supervision of financial conglomerates.

internal audit function, and demonstrate that the projected activities are within the bounds of prudential regulations. In this regard, it is desirable to have an on-site examination of a bank within six months of its opening to ensure that its operations are consistent with the business plan on which basis the license was granted, so that any significant deviations from the plan may be properly accounted for or corrected.

170. Once a bank has been licensed and starts operations, it will become subject to competition and the discipline of the market and will **need to comply** with ongoing supervisory requirements. The supervisors and the market will then, of course, need to apply disciplinary measures if the bank is perceived to be operating in an unsafe way. The prudential mechanisms designed to correct poor management and excessive risk taking are described below. Supervisors will also apply a graduated scale of corrective measures leading up to the closure of the bank if it fails to respond.

B. Governance of Banks

171. Inadequate management is an important factor behind most bank failures. Banking supervisors seek, therefore, as one of their key tasks, to enhance the quality of bank governance.[104] Internal systems and controls, including internal audit functions, as well as persons responsible for these functions, need to be assessed. The **corporate structure** of the bank needs to be transparent and consistent, striking a balance between promoting safe and sound banking, and the flexibility required for effective competition. There should be no uncertainty with regard to management's ultimate responsibility for the bank's actions. The powers granted to the supervisory authority enable it to monitor these areas through the use of on-site inspections and to take remedial action where necessary to protect the interests of depositors. The supervisory authority also needs the power to enforce improvement, including the replacement of top executives, but care always needs to be taken lest the supervisor usurp the role of management.

172. There must be sufficient **checks and balances** in the governance structure. Non-executive directors and shareholders with voting rights must be in a position to exercise oversight over management and their compensation. Also in this context, sufficiently competent and independent internal and external audit functions play an important role. Contact between the external and internal auditors, non-executive directors, and the supervisory authority should permit an exchange of information on the bank's financial condition and management practices.

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[104]The Basle Committee includes as one of the precepts for its "Core Principles for Effective Banking Supervision", that "Supervisors should encourage and pursue market discipline by encouraging good corporate governance (through an appropriate structure and set of responsibilities for a bank's board of directors and senior management), and enhancing market transparency and surveillance" (p. 9, "Core Principles for Banking Supervision").

173. As discussed above, the supervisors need to ensure that the management meets high standards of competency, experience, and integrity, and that at all times **minimum quality standards** are met. It must be able to have unsuitable individuals removed. Such removals will, of course, normally be subject to appeal, although such procedures should not delay rapid action where that is necessary to improve the bank's management.

174. The founders and **large shareholders** of a bank can exercise significant influence over the bank's decision making, and may use it to further their private interests. Such pressures can force management to evade normal lending or collection procedures or to extend credit at preferential interest rates and without due credit analysis.[105] Supervisors need to ensure that safeguards against these conflicts of interest are in place.

Money laundering

175. The removal of restrictions and controls on capital movements and the globalization of credit, foreign exchange and securities markets have facilitated the international laundering of the proceeds from illicit activities. Such activities undermine the security and prompt execution of monetary transactions, and threaten the efficient and transparent manner in which financial enterprises operate.

176. Recommendations designed to prevent the use of banks for **money laundering** have been adopted by the Financial Action Task Force (FATF), and the Basle Committee.[106] The key elements of the April 1990 FATF report include provisions that governments should make money laundering a criminal offense. Banks should keep records of their customers' identity, retain records of all transactions for a period of at least five years, and report questionable transactions. Banks should also establish adequate internal control mechanisms, and educate their staff to detect and prevent money laundering. Bank staff should be given protection against liability when reporting suspicions. Money laundering should be combated primarily by law enforcement agencies, but supervisors should ensure that banks have adequate preventive systems in place. Also, while the supervisory authority is not always empowered to seek evidence of money laundering, it is often required to inform the law enforcement authorities if it comes across such evidence in the course of its normal operations.

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[105]Insider lending is also discussed in section C of this chapter.

[106] Basle Committee "Statement on prevention of the criminal use of the banking system for the purpose of money laundering," (Basle: Bank of International Settlements, December 1988); Financial Action Task Force *"Report on Money Laundering,"* (Paris: Financial Action Task Force, February 1990). The European Council *"Directive on the prevention of the use of the financial system for the purpose of money laundering,"* (91/308/EEC), Official Journal 1991, L 166/77, is also a useful source.

Internal controls and internal audit

177. The supervisory authority should verify the quality and independence of the internal controls and **internal audit function**. Processing systems should be checked for reliability and protection against fraud. Sufficient separation should be made between business generating and accounting functions, particularly in trading areas, where failure to separate front and back office functions can lead to significant opportunities for fraud. Credit procedures and approval limits for different management levels should be established. The role of supervisors is to verify that banks have these mechanisms in place.

178. The internal audit function and adequate **systems and control procedures** are also key to the preparation of reliable accounts and the compilation of accurate data. The external auditor generally relies to an important extent on preparatory work done by the internal auditor, and much of the audit consists of checking and verifying the internal audit. The internal audit function is directed toward the effective management of the bank, and the appropriate recording of the bank's claims and obligations. The supervisory authority must be able to verify that the internal auditor is sufficiently knowledgeable, and empowered to stand up to management when necessary. The supervisory authority also needs to verify that the internal controls are maintained at a level that is appropriate for the types of businesses that the bank undertakes. Internal controls are inspected by the supervisory authorities as part of their routine examination process. To this end, it is important that the internal auditor reports directly to the non-executive board members, the external auditor or, as appropriate, the supervisory authority.

External audits and banking supervision

179. Like any public company a bank is statutorily obliged to prepare and publish annual financial statements audited by an independent and qualified **external auditor**[107] and certified that they provide a "true and fair" view of the bank's financial condition. Supervisors may consider requiring that at least one set of prudential returns per year be audited by an external auditor. External auditors of banks need to meet high professional standards. If entry to the auditing profession is well regulated and requires a high level of professionalism, supervisory scrutiny could be limited to the assessment of sufficient experience in, and knowledge of bank auditing. In some countries, notably in Latin America, banking supervisors maintain registers of acceptable bank auditing firms, while in others the auditor has to be screened annually by the supervisory authority.

180. The external auditor can be a valuable **ally for the supervisory authority**, particularly where skills and resources are scarce, and can provide an efficient mechanism for banks to convey to markets that they are providing accurate information and responding to the signals

[107] See Chapter III.C.

received. In many countries supervisors have traditionally relied heavily on the work of external auditors,[108] often using them in an on-site inspection function. However, a number of cases over the past years have shown that even highly reputable firms with experienced auditors cannot always accurately assess asset quality. When attempting to verify that the financial statements provide a "true and fair view" of the bank's financial condition, a bank auditor would not normally expect to assess the value of specified assets unless directed to do so. In an increasing number of countries the external auditor is obliged by law or regulation to inform the supervisory authorities of circumstances encountered in the course of the audit that are relevant to the effective exercise of supervision.[109] This approach has obvious advantages, although ultimately as the auditor is appointed by the bank, not the supervisory authority, the incentives to act for the supervisors is diminished. When the auditor is under an obligation to inform the supervisor, the auditor should in turn be protected against liability for breach of confidence in such cases.

C. Quantitative Supervisory Tools

181. Supervisors use a range of **quantitative supervisory tools** including various ratios to assess the bank's condition. Such ratios relate to the adequacy of capital, liquidity, large exposures, connected and insider lending, interbank positions and open foreign exchange positions. However, while such ratios are useful, they are not in themselves sufficient to assess the condition of a bank, and more qualitative appraisals, for instance of management, are essential to obtain a complete assessment. As the financial sector grows in complexity, relatively more attention should be paid to qualitative assessments since rules, particularly those based on quantitative measures, may become easier to circumvent and are more likely to be suboptimal. Furthermore, the accuracy of ratios depends on the accuracy of the data used to compute the ratios and too much reliance should not be placed upon them if the underlying data is not considered reliable (see the discussion of asset quality in Chapter III). Sometimes deviant behavior by banks can be detected through peer group analysis, and from their behavior over time. Where feasible, compliance with quantitative prudential standards needs to be assessed on a consolidated basis, as well as on a single entity basis, taking into account exposures of branches, subsidiaries and otherwise related enterprises, domestically and abroad. Experience has shown that without consolidated supervision it is simple for banks to circumvent, for instance, large exposure rules, or loan provisioning rules, thus making supervision ineffective.

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[108] Also see R.M. Pecchioli, *"Prudential Supervision in Banking,"* (Paris: OECD, 1987).

[109] See European Union Council Directive 95/26/EC, "Directive amending directives 77/780/EEC in the field of credit institutions... with a view to reinforcing prudential supervision," the so called "BCCI directive," *Official Journal of the European Communities,* L 168/7 29, (Brussels: European Union, June 29, 1995). In other regions, notably in Latin America, banking supervisors have unlimited access to auditor's working papers, and are allowed to impose sanctions on auditing firms.

Capital adequacy

182. Banks should have **sufficient capital** in relation to the volume and riskiness of their business to absorb losses without using depositors' funds. This capital investment gives owners and managers a powerful incentive to run the bank safely and soundly. Traditionally, the adequacy of the amount of capital available to buffer against losses is measured by means of a so-called capital adequacy ratio. However, capital is simply the difference between the value of a bank's assets and its liabilities to third parties. Its calculation depends fundamentally, therefore, on the value attributed to its assets (see discussion in Chapter III on the difficulties in valuing bank assets).

183. There are **two main types of capital adequacy ratios**: the "risk assets" method as used in the Basle Capital Accord (see Box 6), and the simpler "gearing" or "leverage" ratio, which is the ratio between shareholders' funds and total assets or liabilities. Both types of ratios tend to address credit risk: the risk of nonrepayment of a credit granted by the bank. Some countries, including the United States, apply both systems in parallel.

184. The **Basle capital standard** calls for a ratio between capital and risk weighted assets of at least 8 percent. This ratio, designed to establish minimum levels of capital for internationally active banks, is now applied in the G-10 countries, as well as in the European Economic Area,[110] and in some 80 other countries worldwide. However, even in the industrialized countries, with relatively well managed and highly diversified banks operating in an established financial environment, an 8 percent ratio is generally seen as an absolute floor and the banking systems in most of these countries have ratios that are considerably higher. In developing and transition economies, proper account needs to be taken of the higher risk environment in those countries when determining how the numerator and denominator of the capital adequacy ratio are to be calculated. For instance, the risk weights attached to particular categories of asset could be set at a higher level, to reflect higher risk.[111] For example, if a government has a history of not meeting promptly interest payments on its obligations, the usual zero percent risk weighting may not adequately reflect the risk. Also,

[110]The G-10 countries comprise Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States. The European Economic Area comprises the EU member states, Iceland, Liechtenstein and Norway.

[111]The "Core Principles for Effective Banking Supervision" acknowledges that supervisors should consider requiring higher than minimum capital ratios when it appears appropriate, and stresses the standard is a minimum requirement.

the quantitative standard could be set at higher than 8 percent, or the calculation of capital made more limited, thus requiring more capital (see Box 6).[112] This mechanism imposes a natural restraint on the expansion of a bank's risk asset, since more capital will have to be raised to support those assets.

185. It is sometimes argued that higher capital requirements place banks in such countries at a **competitive disadvantage** relative to banks operating in G-10 countries. However, the counter-argument is that a higher ratio basically reflects higher risk, for which the bank needs an adequate buffer.

186. Therefore, the basic issue when a country describes itself as using the "Basle" model is not whether the system is faithfully copied or not, but whether the appropriate adaptations have been made to reflect **local conditions**. Unless the proper loan provisioning and interest suspension rules have been applied, capital may be overstated to the point where any ratio analysis becomes meaningless.[113] Moreover, ratio analysis needs to be complemented by a qualitative assessment of the bank's ability to manage its risks..

187. The traditional capital adequacy ratios were developed to address the credit risks in the banks portfolio. But banks also carry other significant risks for which a capital buffer is required, notably **market risk**, i.e., the risk of a change in the market value of an asset or commitment. This type of risk is inherent in banks' holdings of trading portfolio securities, financial derivatives, and open foreign exchange positions. Banks are also vulnerable to interest rate risk when there is a substantial difference between the effective maturities, or pricing intervals, between liabilities and assets. Capital adequacy standards against such market risks are now being introduced.[114]

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[112]Also see Dziobek, Frécaut and Nieto, *"Non-G-10 Countries and the Basle Capital Rules,"* IMF PPAA 95/5 (Washington: International Monetary Fund, 1995).

[113]Dziobek, Frécaut and Nieto, *"Non G-10 Countries and the Basle Capital Rules,"* (IMF, 1995).

[114] See Basle Committee, "Amendment to the Capital Accord to Incorporate Market Risks," (Basle: Bank of International Settlements, January 1996). This also envisages the use of integrated Value at Risk models (VAR), and Tier III capital explained briefly in Chapter III.B, Box 1.

Box 6. The Basle Capital Accord[1/]

The Basle Capital Accord of 1988 defined capital, the numerator in the risk asset ratio, as follows: Tier I capital includes issued and paid up share capital, non-cumulative preferred stock and disclosed reserves from post-tax retained earnings. It is the highest quality capital, and should form no less than 50 percent of total regulatory capital. Tier II capital can include a range of other items, including: undisclosed reserves that have passed through the profit and loss account; conservatively valued revaluation reserves; revaluation of equities held at historical cost can be included at a discount; general loan loss reserves, up to 1.25 percent of risk weighted assets; hybrid debt instruments available to support losses without triggering liquidation; and subordinated term debt, up to a maximum of 50 percent of Tier I capital. Goodwill and investments in other banks and financial institutions should normally be deducted. For most banks the use made of Tier II capital is much less than 50 percent.

The bank's assets are divided into four or more categories of risk, for instance, commercial loans, mortgage lending, interbank debt, and government debt. For each risk category, a risk weighting is established. This weighting, or coefficient, is applied to the total amount of assets in each category. Normal credit risks are assigned a 100 percent rating, while the other risk categories carry a lower weighting, based on the risk of that category relative to normal credit risks. The amounts obtained for each of the categories are added to obtain the total of "risk weighted assets" which is the denominator of the risk weighted ratio. Off balance sheet items are also included in the ratio, converted into credit equivalents by applying conversion factors reflecting the degree to which an off-balance sheet items reflect expected on-balance sheet credit commitments of the bank.

The Basle Committee considers that the risk weighted ratio has three advantages over the gearing ratio: First, it does not penalize banks for holding relatively low risk assets such as government securities. Second, it allows for incorporation of off-balance sheet items, and third, it allows for better international comparisons of banks with different balance sheet structures.

[1/] Basle Committee, *"International Convergence of Capital Measurement and Capital Standards,"* (Basle: Bank for International Settlements, July, 1988)

Liquidity

188. A key element of banking supervision is monitoring the **liquidity** of banks. This task becomes even more critical when a bank starts to encounter problems, and market availability of liquidity may decline for that bank. The interbank deposit market, nationally and internationally, is particularly sensitive to hints of difficulties faced by a bank, sometimes overreacting by rapidly withdrawing funding. Although this is an example of the very direct effect of market discipline, it could force the bank to liquidate assets quickly, moving the market against it, and possibly force the bank into insolvency, even if initially the bank was merely illiquid. In a certain sense, then, market discipline may be very harsh. It can be argued

that this can be alleviated to a certain extent for solvent banks, by lender of last resort liquidity support as discussed above, but a bank can not be sure that a well designed LOLR will automatically be available to it.[115]

189. There are **no internationally agreed prudential standards** on bank liquidity, although the Basle Committee has issued material discussing some of the fundamental issues.[116] But supervisory authorities require banks to have adequate internal systems to monitor and control their liquidity needs and establish contingency plans for periods of liquidity stress, either resulting from overall market problems or from institution specific crises. For large internationally active banks, systems need to be very sophisticated, and include simulation models for a variety of scenarios. An over-dependence on one or a small group of funding sources should be avoided. Limits on funding from a single source, or connected group of sources are applied by a number of countries.

190. In many countries, central banks require commercial banks to maintain high reserve requirements in relation to deposits. Although such reserves are intended primarily for monetary purposes, they do serve some prudential purposes as well. Some central banks or prudential authorities also impose **liquid asset requirements**; such requirements ideally allow banks to select from a range of liquid assets and not become schemes for obligatory holding of government securities. In general, banks need to be encouraged to retain a certain proportion of their assets in liquid and low risk securities that can generate cash quickly.

191. Access to **central bank liquidity facilities,** such as Lombard facilities and discount windows for rediscount of government paper, also form a part of banks' contingency planning for liquidity emergencies. Such borrowing is costly, and banks need to hold the collateral required for access to such facilities, so banks will typically avoid using it. Central bank facilities may however play a relatively important role when local interbank and other money markets are thin or segmented.

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[115]See Chapter IV.A

[116]Basle Committee, A framework for measuring and managing liquidity in *Report on International Developments in Banking Supervision* (Basle: Bank for International Settlements, September 1992), Number 8, Chapter VI. The "Core Principles for Effective Banking Supervision" recognizes the elements of strong liquidity management ("good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, and contingency planning") and recommends that banks have a diversified funding base and maintain adequate liquid assets.

Credit diversification

192. Well-managed banks limit their exposure, including off-balance sheet items, to a single borrower or related group of borrowers, in order to **diversify risks** and to avoid the risk that failure of one large borrower or related group of borrowers may lead to excessive losses. The supervisor monitors such credit concentrations and generally prescribes limits. The Basle Committee has called for and the EU has set a limit of 25 percent of regulatory capital[117] for exposures to single borrowers or related groups of borrowers. The EU defines an exposure larger than 10 percent of regulatory capital as a large exposure. In the United States, federal regulations set a limit at 15 percent of a bank's regulatory capital for unsecured loans and an additional 10 percent for loans secured by specific and liquid marketable security. The EU has set the aggregate limit for all large exposures at 800 percent of regulatory capital. Other countries, e.g., the United States, have no aggregate limits. Other forms of risk concentration, which are generally not subject to strict ratios, are concentrations in specific economic sectors, e.g., the real estate or agricultural sectors, or geographical concentration. To be effective, it is essential that compliance with risk diversification rules be assessed on a consolidated basis, taking into account exposures incurred by branches, subsidiaries, or other related enterprises. Gross exposure, not taking account of collateral, is a conservative basis for the application of exposure limits.[118] If deductions are to be made, only very secure collateral, under the direct control of the bank, and valued very conservatively, should be taken into account. Many supervisors set standards for the maximum percentage of the value of collateral that can be taken into account, especially when the values of certain types of collateral are volatile.

193. The **definition of a related group** normally takes into account conditions in a given country and may require a degree of judgment. In the EU, two or more borrowers constitute a single risk if one of them directly or indirectly controls the others, or if they are so closely related, that if one were to experience financial problems the others would be likely to encounter repayment difficulties. Indications of such relationships include common directors, cross guarantees, or common ownership.[119] In a number of cases, the supervisors will need to

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[117]The Basle Committee, "Measuring and controlling large credit exposures," (Basle: Banking of International Settlements, January 1991).

[118] The existence of risk-based capital requirements places an implicit limit on credit exposures since to take on more credit risk, additional capital will need to be raised. At some point, the cost of raising additional capital becomes prohibitive, relative to the benefits, thereby limiting extensions of credit. However, concentrations within the general risk categories (e.g. to a connected group) will not be adequately accounted for within this framework and may require explicit limits.

[119]See European Council, "Directive on the monitoring and control of large exposures of

(continued...)

exercise judgment. The use of consolidated accounts is, in itself, not a sufficient criterion as exposure by unconsolidated companies owned by the same owner should also be seen as related.[120]

Connected lending

194. **Loans to counterparties connected to the bank**, e.g., directors, managers, shareholders and their families have contributed to banking problems in many cases; large loans to such borrowers, or to companies owned by them, can easily become uncollectible and cause losses. In view of the increased risk resulting from the conflict of interest between the bank and the borrower, many supervisors reserve the right to deduct such loans from capital, when, in the judgment of the supervisor, the loan was not made on an arms length basis. Connected lending represents an obvious breakdown of market discipline and poses considerable risk to the bank. Such loans are normally required to be disclosed and they may need the intervention of the supervisor.

Foreign exchange exposure

195. Well-managed banks should possess a system of internal limits and monitoring mechanisms for their **open positions in specific currencies**, including sublimits on spot positions and various forward maturities when derivative instruments are used, as well as an overall limit for the net open position.[121] Uncovered open positions in foreign exchange have been an important factor in many banking problems. Since position data is considered to be proprietary, and is thus not usually available to other market practitioners, such open positions are closely monitored by supervisors and often subject to limits, which are related to exchange rate volatility.

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[119](...continued)
credit institutions," *Official Journal* (92/121/EEC), L 29/1, Article 1m.

[120]In the United States, consolidation depends on a series of tests including such factors as whether the loans have a common repayment source, common control, financial independence, or are being used for a common end.

[121]The "Core Principles for Effective Banking Supervision" recommends that banking supervisors ensure that bank management has set appropriate limits and implemented adequate internal controls for their foreign exchange business.

196. **Several methods** are used to measure aggregate positions.[122] The appropriate summary measure of an open position depends on the correlation among exchange rate changes between the currencies in which a bank holds open positions. If exchange rate movements are perfectly correlated, the net aggregate position is appropriate, while if movements are completely uncorrelated, then the gross aggregate position is in order. The shorthand aggregate position is a compromise between the other two measures, and has been recommended by the Basle Committee and the EU.[123] On the other hand, some countries intend to include foreign exchange positions in an overall approach to market risk capital adequacy and allow banks with adequate management and control systems on their dealing operations to hold foreign exchange and other proprietary market positions limited only by the availability of capital to support them.[124]

Limits on nonbank activity

197. The objective of **limits imposed on banks' equity holdings** in non-financial enterprises is to prevent banks from using depositors' money to take risks outside the scope of traditional banking, and to limit conflicts of interest and concentrations of financial power. Excessive diversity of activities and equity interests could also create difficulties in consolidating accounts and exercising supervision. Banks' business is therefore often limited to well-defined financial activities, where managements have the necessary expertise. Also, within the supervisory authority, expertise is required in those areas in which the bank is conducting business. If expertise is limited, limiting the banks activities ensures that the bank does not take risks that cannot be supervised.[125]

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[122] For example, the definitions typically used are: "gross aggregate position," which is the sum of all open positions in foreign currency, short or long; "net aggregate position," which is the difference between the sum of all long positions and all short positions; and the "shorthand method," adopted by the Basle Committee and EU, which separately sums all short positions and all long positions, the larger of the two totals is to be regarded as the overall open position.

[123]Basle Committee, *"Amendment to the Basle Capital Accord to incorporate market risk,"* January 1996, p. 23. The report also discusses the use of a bank's own VAR model (see Chapter III.B, Box 1) , which can fully take account of correlations between currencies.

[124]Also see Philipp Hartmann, "Capital Adequacy and Foreign Exchange Risk Regulation: Recent Developments in Industrial Countries," *Special Paper No. 77, Special Paper Series,* (London: London School of Economics Financial Markets Group, 1995); and Basle Committee, *"Amendment to the Basle Capital Accord to incorporate market risks"* 1996.

[125]The "Core Principles for Effective Banking Supervision" do not explicitly advise supervisors to limit nonbank activities but do advocate that the scope of activities governed by

(continued...)

198. The scope of **permissible financial activities** differs across countries. A broad distinction can be made between banking systems where banks are permitted to engage in securities business and where they are not. In the EU, banks are permitted to engage in securities business under their own name or by means of a subsidiary, and frequently have common ownership with insurance companies. In some countries, banks also have substantial interests in industrial companies. In other countries, such as the US and Japan, banks are more narrowly confined and are permitted to engage in securities business only to a limited extent. In all cases, the supervisory authorities should be aware of banks' equity holdings, and be able to force the bank to divest when necessary.

VI. SUPERVISORY OVERSIGHT

199. This chapter examines the **attributes of an effective banking supervisory system**. It is based on practice established in major supervisory authorities, and to a large extent reflected (sometimes only implicitly) in the published recommendations of the Basle Committee.[126] The first issue addressed is the degree of supervisory autonomy which is necessary to permit the supervisory authority to perform its responsibilities without undue political interference and to allow the authority to acquire and allocate its financial and staff resources. The second issue relates to the tools that should be provided to the supervisory authority to carry out its mandate. The third section addresses the powers of the supervisory authority to request information from and cooperate with other financial sector supervisors and law enforcement agencies. The fourth issue raised pertains to the choice of location for the banking supervisory function within the public sector. The fifth section discusses the characteristics of off-site analysis and on-site supervision. Finally, this chapter discusses the appropriate range of remedial and punitive measures available to the supervisory authority.

A. Autonomy of Banking Supervision

200. In order to allow the supervisory authority to resist undue pressures from banks themselves, their shareholders, depositors and other creditors, borrowers, or the government, the objectives and purposes of the supervisory authority and its **autonomy** ideally should be

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[125](...continued)
banking licenses be clearly defined and that supervisors must be satisfied that banks have in place a comprehensive risk management process to identify, measure, monitor, and control all material risks.

[126]See the various papers now published in the *Compendium of Documents* produced by the Basle Committee on Banking Supervision, Basle, April 1997.

as firmly spelled out and entrenched as possible by law. It is also in the interest of the banking sector to have certainty regarding the scope of authority of the supervisory authority.[127]

201. The law detailing the authority of the supervisor normally contains the following **objectives**: (a) to protect the supervisory agency against undue political influence in the exercise of its mandate, specifically concerning decisions with regard to individual banks, the areas of licensing, vetting of large shareholders and managers, compliance and withdrawal of licenses, closure and liquidation; (b) to provide authority for the issue of prudential regulations and standards, and to protect the supervisory agency against undue outside influence regarding the issuance of such regulations and their content, and of other regulations issued in the interest of the proper exercise of banking supervision; (c) to protect the agency against undue influence in the implementation of its loan classification and provisioning rules, monitoring, and inspection tasks; (d) to protect proprietary information of the commercial banks and of the supervisory agency itself against unwarranted disclosure; (e) to protect staff of the supervisory agency against personal liability for decisions taken in the exercise of their duty; (f) to ensure financial autonomy of the supervisory agency; (g) to ensure the autonomy of the agency in its internal organization and procedures; and (h) to create an appropriate system to ensure the accountability of the supervisory authority.

Political autonomy

202. To be effective, a supervisor needs sufficient political autonomy to take necessary measures. There are many examples where supervisors have been persuaded to exercise forbearance, and to believe that with a delay the bank could work its way back to being financially sound. However, a near insolvent bank faces strong incentives to assume additional risks, and hence forbearance has rarely been a successful solution.[128]

203. While there is no way of legally constructing a **supervisory regime** that will entirely eradicate the possibility of undue influence being exerted, there are a number of areas where appropriate policies may reduce the risk of such influence being applied. Among these are: (1) the legal status and powers of the supervisory agency; (2) the location of the supervisory function; (3) the dichotomy between rules and discretion; and (4) the need for transparency, an appeal and judicial review process, market discipline, as well as professional competence,

[127]The "Core Principles for Effective Banking Supervision" support a system of banking supervision whereby clear responsibilities and objectives are delineated and operational independence and adequate resources are maintained. The objectives are similar to those suggested above, although the Basle Committee explicitly refers to the possibility of multiple supervisors, whereas a single authority is envisioned here.

[128]Countries with an effective supervisory authority have sometimes found limited forbearance useful when banks are viable business institutions, although technically insolvent.

and (5) a fixed term of tenure for the head of the banking supervisory authority, appointed by the legislative body.[129]

204. Appropriate supervisory policies and procedures can be identified on a **rules versus discretion** continuum. A system heavily dependent on compliance with transparent rules and regulations lies at one end of the spectrum, while a system that gives the supervisor objectives but leaves the agency free to use whatever powers it thinks fit to achieve its goals lies at the other. The justification for discretion is that bank supervision is as much about making qualitative judgements about the integrity and competence of management as it is about maintaining compliance with quantitative rules or prudential ratios. However, one major problem with allowing supervisors discretion is that there is no guarantee it will be used impartially and objectively. Much depends on the integrity, public credibility and competence of the supervisor, which can only be earned over time, as well as on the broader political and institutional environment.

205. An effective banking supervisory system therefore needs to be **sufficiently transparent** so that the supervisors can be seen to be exercising their powers in a way which is beneficial to the objectives of maintaining a stable and sound banking system. One way of achieving such transparency is to provide for periodic reports to be published describing the actions that have been taken by the supervisory authority to achieve its objectives. In this way the supervisor's performance can be monitored by government, by the supervised banks, as well as by the public at large. Of course there may well be justifiable reasons why the supervisor's actions in specific cases can only be revealed sometime after the event, but the knowledge that they will ultimately have to be revealed can be a powerful tool.

206. The institution of a system in which banks, as well as individual shareholders, directors and managers can within the limits of the law **appeal against the actions of the supervisor** is a useful element in ensuring the accountability of supervisors. It thus helps justify giving the supervisor discretion. It also reinforces the supervisor's autonomy from undue political influence.

207. A **supervisory process based on best market practice** is likely to retain more support from the banking sector. This may give the supervisor more influence in resisting pressures that derive from special interest groups. A supervisory body that can demonstrate a high degree of professional competence may find it easier to earn a position vis-a-vis the interested parties that enables it to resist improper pressure more readily .

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[129]A fixed term can also have disadvantages. The power of the supervisor can, for instance, be weakened when the term of office is close to expiration. If the term is renewable, the supervisor may be subject to pressure in order to secure a renewal. On balance, however, the advantages of a clear mandate for a fixed term period seem to outweigh any disadvantages.

Staffing and resources

208. Without sufficiently **qualified staff**, the supervisory authority cannot fulfil its mandate. The banking supervisory authority needs to develop an on-site bank examination capacity with investigative resources, an off-site analytical capability, as well as being open to market intelligence and possessing an awareness of macro-prudential developments. Supervisors need examiners with knowledge and skills of the business of banking to be able to assess management adequately, including the control systems they employ. They need sufficient familiarity with banks' operations to know where to look and probe for weaknesses which may not be evident on the surface. Banking supervision staff needs to have the ability to evaluate credit approval and monitoring systems, to assess the payment capacity of debtors, adequacy of provisions, etc. Increasingly, inspectors needs skills required to assess the efficacy of sophisticated risk management systems, and the adequacy and vulnerability of electronic data processing systems used by banks. Off-site analysts need to be able to absorb and assess the information and direct examiners to areas of weakness. Skills to detect inconsistencies and identify potentially damaging trends are also important. In addition, when the supervisor suspects fraud or other illegal activity which may threaten the soundness of individual banks, he or she needs the capacity to investigate quickly and in depth. The banking supervisory authority also needs to develop effective working contacts with other supervisory bodies both at home and abroad.

209. The **banks can contribute substantially** to the work of supervision. For example, banks can complete their own calculations of required prudential ratios. Much of the work going into an examination can be facilitated by the banks, particularly by the internal audit function and external auditors.[130] The supervisory authority may also contract external computing and information systems specialists, lawyers, forensic accountants, former commercial bankers or others with special skills, to conduct specialized tasks.

210. In order to be able to attract and retain qualified staff, a supervisory agency needs **flexible pay and personnel policies** which will enable it to recruit at appropriate levels people with the requisite skills. In many countries excessive differentials between pay levels for bank inspectors and commercial bankers lead to excessively rapid turnover of qualified staff and conflicts of interest. It is essential that banking supervisory staff be seen to be free from conflict of interest, not be financially connected to any bank, nor to have obvious political or business affiliations.

[130] See Chapter V.B. for more details on the interactions between supervisors and internal and external auditors.

211. The supervisory authority also needs some **financial autonomy**. It may have its own sources of income, for instance in the form of direct funding as part of central bank expenses, or direct assessments upon the banks,[131] or as a direct lump sum budget allocation—or a combination of these, with freedom to use these funds, provided they are used in the proper exercise of its mandate. General oversight of a state accounting office could be considered, as well as an independent external audit.

Immunities

212. Banking supervision can affect substantially the conduct of business of a bank, and the property rights of its owners. Situations can arise in which the bank, its owners or managers feel that their interests have been unjustly damaged by the actions of the supervisors. Although it should be possible for interested parties to appeal against any specific decision of the supervisory authorities with regard to an individual bank, the process is more effective if the **supervisors themselves are not personally liable for damages** caused by any actions legitimately performed in the course of their duties. The supervisory authority as such could conceivably be held liable for damages, if it took obviously unreasonable and damaging decisions against the bank, its owners or managers. The criterion of reasonableness should only take into account the circumstances as they existed at the time the action was taken; liability need not be so strict that it could unduly hinder taking sufficiently speedy supervisory decisions and actions.

B. Powers of the Supervisory Authority

213. Ideally, the supervisory authority is endowed by law with a clear mandate and powers to carry out its function. The **law defines the scope of authority of the supervisor** and confers authority to license and to withdraw licenses of financial institutions, approve new owners, issue prudential regulations, obtain periodic prudential reports, conduct on-site inspections, take corrective actions (including the imposition of restrictions on banks' business activities), and close and liquidate banks. Actions taken by the supervisor to remedy an unsafe or unsound situation, have immediate legal effect, notwithstanding appeals procedures. The question of which types of financial institutions are subject to supervision is answered differently from country to country. Banks, credit unions, cooperative banks, mutual fund-type institutions, investment funds are some of the categories of institutions that are included. For the purposes of this paper, the scope of the banking supervisory authorities is, as noted earlier, limited to banks defined as institutions that make it their business to take deposits, or other nominally repayable funds from the public and grant credits and make investments for

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[131] Direct assessments are normally based on the size of the bank, but can also contain some element of cost based fees, so that those banks onerous to supervise are not subsidized by the well run bank that costs little to supervise.

their own account.[132] For a supervisory system to be effective, such institutions need to obtain a banking license and thereby submit themselves to banking supervision. Unlicensed institutions that perform banking activities can then be prosecuted.[133]

214. An effective supervisory authority has at least the following powers:

- Exclusive authority to license and to withdraw licenses. For optimal effect, these two functions should be exercised by one and the same agency.[134]

- Authority to issue prudential regulations and standards. Ideally detailed requirements are not in the law itself as the parliamentary procedure may be insufficiently flexible to incorporate new or revised standards efficiently and quickly. The broad areas in which the supervisory authority is authorized to issue regulations are, however, normally laid down in law so providing an element of stability to the supervisory framework.[135] Preferably the banks are consulted on proposed changes, avoiding, however, the possibility of undue influence or "regulatory capture."

- Authority to obtain periodic reports in the format and periodicity established by the supervisory authority.[136] Banks can be required to show their own assessment of their compliance with the prudential ratios and limits. Untimely, incomplete or incorrect submittal of the reports are subject to an administrative penalty, and ultimately to prosecution.

- Authority to conduct on-site inspections. These are necessary to verify the information submitted, and are also essential to assess management quality. Inspectors have full

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[132]The "Core Principles for Effective Banking Supervision" clearly states that the term "bank" should be reserved for those institutions licensed and supervised as banking institutions.

[133]Also see article 1 of the European Union, "Directive on coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, and amending Directive 77/780/EEC," (89/646/EEC), Official Journal of the European Communities, No. L 386/1, (Brussels: European Union).

[134]See footnote 26.

[135] The supervisory authority is normally authorized to issue regulations in at least the following fields: minimum initial capital in the context of bank licensing, capital adequacy, liquidity, risk diversification, market risks such as open foreign exchange positions, securities, interest rate risk, equity investments, loan classification and provisioning, internal control systems, and accounting and reporting. See Chapters III.A and B, V.C and VI.B.

[136]The content of such reports is described in Chapter III.B and V.C.

powers to enter the bank, inspect any information they consider useful, in whatever form, and have access to the management and any staff of the bank. Refusal to permit an inspection or to refuse cooperation with the inspector is subject to an administrative penalty, and ultimately to prosecution. Supervisors also have the right to obtain information from all consolidated subsidiaries or equity holdings of the bank, as well as connected non-consolidated entities.[137] Staff from non-supervisory agencies do not participate in, nor are the results of an inspection shared routinely with them.

- Authority to take corrective actions. In case of breach of prudential regulations or of unsafe and unsound banking activities, the supervisor should be able to impose a progressively severe set of administrative penalties on individual managers of the bank, have them removed from office, or issue "cease and desist" orders constraining the business activities of the bank. Such action, which falls short of conservatorship or closure, can be kept confidential or publicly announced, according to the circumstances.

- Authority to take emergency action. Such actions can consist of the removal of management powers and the imposition of conservatorship. The conservator works under the close supervision of the supervisory authority, and reports regularly. The conservator could be given the authority to obtain professional assistance, such as legal advice or auditing services.

- Authority to close and initiate the liquidation of banks. In cases of insolvency, gross and repeated breaches of regulations or other extremely unsafe banking practices, in cases of criminal behavior by, or tolerated by, the bank, and in cases of continued non-compliance with the licensing requirements, the supervisory authority has the powers to withdraw the license and close the bank. This includes the power to take control of the assets, and to prevent looting of the bank. Liquidation itself should not normally be performed by the supervisory agency itself.

- Authority over the bankruptcy of banks. In light of the extreme vulnerability of confidence in banks, which could be very seriously damaged by an unfounded bankruptcy suit, a form of control by the supervisory agency over whether bankruptcy proceedings are started against a bank is sometimes considered.

C. Interaction with Other Financial Sector Supervisors and Law Enforcement Bodies

215. The increasing **linkages between domestic financial sectors and the internationalization** of financial services have greatly increased the need for closer cooperation between different financial sector regulators domestically and internationally. The

[137] See Chapter VII.B.

combat of criminal activities involving the financial sector has required closer cooperation with law enforcement agencies as well.

216. **Cooperation between supervisors of different financial sectors** are necessary, for instance, when there are corporate linkages between banks, securities and insurance companies.[138] It may be necessary to obtain information about prospective bank managers that have previously worked in other financial institutions. The exercise of consolidated supervision may require taking measures against an establishment of a bank, in another jurisdiction. Cooperation among different financial sector supervisors may be made difficult by different laws applying to banking, insurance or securities business, for instance in the areas of licensing, prudential regulations and accounting standards. It may be difficult to produce consolidated accounts of banks, and insurance companies, for example. The exchange of information between supervisors can be hindered by confidentiality constraints that apply to each of the different regulators. Barriers of this nature should be removed. Supervisors over different financial sectors should be able to freely exchange information on individual institutions.[139]

217. It is essential that the supervisory authorities retain the trust of the banks, in order to be truly effective as supervisors and to be able to take proactive measures. Supervisors generally need, at their disposal, well documented and easily accessible information about the banks. This makes the supervisory authorities an ideal witness in court cases against banks and their clients. However, if inappropriately used as witnesses, supervisors risk losing the confidence and trust of the banks. Thus, the supervisory authorities may need to be protected against excessive **requests by the law enforcement authorities to provide information** about banks. They should, however, be prepared to provide information in case of specific suspicions of criminal behavior, money laundering or tax fraud, and upon an official request from the authorities.

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[138]For issues related to the regulation and supervision of conglomerates that provide such financial services as banking, securities, investment management, and insurance see "The Regulation and Supervision of Domestic Financial Conglomerates", by David Scott, Policy Research Working Paper 1329, The World Bank, August 1994.

[139]The Joint Forum on Financial Conglomerates is currently working to document existing impediments to information exchanges among the supervisors of banks, securities firms, and insurance companies.

D. Location of the Banking Supervision Function

218. Different traditions and systems exist for locating the banking **supervisory function, inside or outside the central bank.**[140] Whichever institutional arrangement is chosen, it is of key importance for the effectiveness of banking supervision that the position of the supervisory authority, whether inside or outside the central bank, be especially circumscribed in law and a minimum set of institutional conditions be met, as described above (such as independence from political pressure, adequate coordination of banking supervision and monetary policy, and adequate staffing and resources). If these conditions are met, the location of the supervisory function becomes less relevant for practical purposes, although the autonomy and independence of the supervisory authority may be easier to maintain in countries with relatively weak institutional structures, when the supervisory function is located in the central bank, than when it is a separate agency. This is the case in particular when the central bank itself has a high degree of autonomy and independence.[141]

E. Off-site Analysis and On-site inspections

219. Banking supervision requires **off-site monitoring and analysis, as well as on-site inspections** of banks' records, operations and management. While the balance between on-site inspection and off-site supervision can vary considerably between countries, the supervisory authority needs to have both the right to require production of whatever information it needs as well as the right to conduct on-site inspections. The verification of the reliability of the reported information, its accurate reflection of the risks, the quality of assets, and the effectiveness of management and internal controls can only be effectively tested by intensive and well-targeted on-site inspections.[142] This can also provide indications on the effectiveness of external audits. The supervisors' inspections should encourage management to take appropriate precautions against imprudent transactions, and internal systems that prevent excessively risky transactions.

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[140]For a discussion of the question whether the supervisory function should be located inside or outside the central bank, see José Tuya and Lorena Zamalloa, "Issues on Placing Banking Supervision in the Central Bank, in *Frameworks for Monetary Stability*, edited by T.J. Baliño and C. Cottarelli, (Washington, IMF, 1994)

[141]Similarly, if the supervisory authority were to be based in a different institution, the autonomy and independence of that institution should be assured.

[142]In some countries, on-site inspection is carried out by auditors acting under the specific instructions of the supervisory authority.

220. Periodic prudential reports are the basis for the off-site analysis of the condition of the bank. Off-site reports can also be used as **input for an early warning system.**[143] Noncompliance and submission of false or incomplete data are a punishable offence. Effective supervisors are also authorized to obtain from the bank any additional information they consider necessary for effective supervision. In addition to reports, off-site information could consist of a permanent file on the management and organization of the bank, as well as a collection of the bank's financial statements and articles of association, and an operational file on the contacts between the bank and the supervisory authorities, including records of any remedial measures that have been prescribed and taken, and any permissions that have been granted or refused pursuant to prudential requirements.

221. On-site inspections are typically based on the following **operational principles:**

- A comprehensive on-site inspection program is prepared for each bank, setting out the coverage, time frame and periodicity of the inspections. On-site inspections are announced in advance, unless there is a suspicion of fraud or bad faith.

- Inspections focus on asset quality, management, and risk management systems, as well as on formal compliance with regulations.

- Inspectors use off-site data, results of previous inspections, market information and other sources as the input for inspections. Inspectors should also have access to any information and staff, specifically including the internal and external auditors and their reports.

- The supervisory authority should know the institution well, its activities, its key staff, and build a relationship of trust and professional respect with the individual banks. The bank must feel free to discuss problems openly, and in full confidence, without fear of provoking measures by other public agencies.

- Prudential on-site inspections are carried out solely by supervisory staff, or by other qualified persons designated by the supervisory authority.

- An inspection is followed up within a specified time by a report to the management and the board of the bank to ensure that any problems are addressed. Conferences between the bank and the supervisory authorities to discuss the results of the inspection are a useful supervisory tool.

- The report contains proposals for prompt remedial measures and proactive recommendations, as appropriate. Follow up inspections may be needed to monitor implementation.

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[143]The content of such reports is described in detail in Chapter III.

- When dealing with branches or subsidiaries of foreign banks, the supervisory authorities must have as much access as possible to establishments of its banks abroad, allow access to foreign supervisors, and establish general good working contacts with the foreign supervisory authority.[144]

F. Remedial and Punitive Measures

222. Supervisory authorities need a flexible range of remedial and punitive measures to **correct unsafe or unsound banking practices and to punish transgressions.**[145] Remedial actions are intended to improve the bank's operations before the problem becomes insurmountable, while punitive actions are designed to deter management from breaches of the regulations and unsafe and unsound banking practices. These measures represent a backstop when market discipline cannot, perhaps due to insufficient information, or does not operate effectively.

223. The supervisory authorities need to be able to **tailor their response to the seriousness of the problem**. Whenever possible, the initial actions would be remedial. The supervisor would start by drawing attention to shortcomings and requesting management's written commitment to take corrective action. In more severe cases, when a more formal arrangement is appropriate, an exchange of letters between the bank and the supervisory authorities could be used. When compliance is inadequate, a next step could be a written warning by the supervisory authorities, stating that it will take formal action if the bank does not take corrective action against specified breaches or unsafe and unsound banking practices.

224. Supervisory actions need to be **carefully prepared and implemented**, especially when they are not legally enforceable, to establish a track record against a bank, in order to defend such actions in a court of law, or, possibly, before the political authorities. A track record of action should also lay the groundwork for possible further supervisory action, such as conservatorship, or license withdrawal. The bank must never be in a position to claim that it had not been informed of the seriousness of the supervisors' view of the situation, except, of course, in rapidly developing cases or in cases of fraud.

225. The supervisory authorities also need to be able to take **legally binding action** to enforce compliance with specific remedial measures. Such actions could consist of a "cease and desist" order, ordering a bank to improve operations, close or limit deposit-taking or certain types of credit business, or other actions to correct specific breaches or unsafe and unsound practices. A next step could be a dismissal order against a director or manager who can no longer be considered fit and proper, as a result of major management failings or refusal to comply with corrective orders. In some cases, punitive measures, such as fines levied

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[144]See Chapter VII.B.

[145]See World Bank Guideline No. 13, Enforcement

against the manager or director personally, can be effective. The most effective measures are those tailored towards remedying the deficiency. For instance when capital is below the required level, a first step could be to prohibit dividend payments. The banking law normally specifies that noncompliance with a corrective order or dismissal order is a punishable offence, potentially subject to action by the prosecuting authorities, and leading to substantial fines or prison sentences.

226. As measures of **last resort**, but, in urgent cases also as a first measure, when the financial condition of the bank has deteriorated to a potentially terminal level, or there is evidence of serious criminal activity sanctioned by management, the supervisory authorities would have the authority to impose conservatorship or withdraw the license, in order to rehabilitate the bank or force its closure and liquidation.

VII. Cross-Border Supervision of Banks

227. This chapter discusses **international aspects of maintaining banking soundness**. It identifies some of the key problem issues in supervising banks and banking groups with cross-border operations, that is, the location of the home supervisor, licensing of internationally active banks and their establishments and affiliates abroad, cross-border compliance with prudential standards, information flows, inspections, cross-border remedial action, shell banks and parallel owned banks, international financial conglomerates, and international bank liquidation.

A. Evolution of Best Practices

228. The key challenge for supervisory authorities of internationally active banks has been to ensure that **no activity of these banks escapes effective supervision**, and that coordinated remedial action can be undertaken when necessary. These challenges have become more salient over the past few years. Banks in industrialized countries have expanded their business into emerging and transitional economies, using their comparative advantages in producing and distributing financial services. Banks in emerging and transitional economies have, but to a much lesser extent, expanded their activities in the industrialized countries, other emerging-market countries, and offshore banking centers as they attempt to meet the competition from the major banks, and to take advantage of increased opportunities made possible by the relaxation of domestic regulation.

229. The **cross-border expansion** of banks can be expected in general to increase the efficiency of global capital markets, as frequently the entrance of highly rated foreign banks spurs competition among the domestic banks. However, cross-border expansion can create a variety of difficulties for supervision. This is particularly true for emerging market countries that are still developing their accounting or legal systems, and where supervisory resources are limited. First, as evidenced by the well-known case of BCCI and the lesser-known case of the

Meridien International Bank, the creation of various types of corporate structures across international borders can be used to escape regulation and effective supervision. Second, the growing ability and propensity for banks to shift their activities to offshore tax havens presents a channel whereby domestic prudential regulations can be easily circumvented. Third, when accounting practices are relatively unsophisticated and disclosure laws are limited, cross-border transactions can be used to conceal problems at domestic financial institutions by booking problem assets with subsidiaries or other offshore entities. Finally, offshore transactions can be used to facilitate or commit outright fraud. Incentives for prudent behavior are varied across different jurisdictions, leading some institutions to seek out countries in which high-risk activities go unnoticed.

230. The **circumvention of domestic prudential regulations,** particularly under-reporting of nonperforming assets through offshore entities, increases the risks taken by the bank or banking group as a whole and implies that bank capital may be insufficient. Fraudulent activities that are hidden by relocation to under-regulated cross-border establishments create losses that will ultimately have to be borne domestically. While supervising banking establishments across borders can be difficult and strain meager resources, the cost of not adequately doing so could, in the end, be greater.

231. Basic principles and standards on a number of aspects of supervision and regulation of cross-border banking have been developed by the Basle Committee on Banking Supervision,[146] starting with the so-called **"Basle Concordat" in 1975.** Implementation of the principles in the Concordat was for many years on a best endeavors basis. Following the BCCI failure, the Basle Committee's issued its "Minimum Standards" in 1992 (see Box 7.), underlining and further developing some of the main concepts of the Concordat with regard to cross-border supervision.[147] To implement the standards a number of countries have concluded bilateral exchanges of letters or signed Memoranda of Understanding.[148] Subsequently, a working group of the Basle Committee and the Offshore group of Banking

[146] See the Basle Committee, "Report on the supervision of bank's foreign establishments," (Basle: Bank for International Settlements, 1975), and the Basle Committee, "Principles for the supervision of bank's foreign establishments," (Basle: Bank for International Settlements, 1983).

[147]See Basle Committee, "Minimum standards for the supervision of international banking group and their cross-border establishments," (Basle: Bank for International Settlements, 1992)

[148]See the Office of the Comptroller of the Currency, *Quarterly Journal*, (1996), for example, describing supervisory agreements between the United States and Germany.

Supervisors is seeking to resolve a number of issues relating to the implementation of the minimum standards, and has recently issued a set of recommendations to supplement the minimum standards.[149]

Box 7. The Basle "Standards"

In 1992, following the closure of BCCI, the Basle Committee reformulated the principles behind the Concordat into minimum standards which G10 supervisory authorities undertook to observe. They subsequently invited other supervisory authorities to do so as well. The standards are:

1. All international banking groups and international banks should be supervised by a home-country authority that capably performs consolidated supervision.

2. The creation of a cross-border banking establishment should receive the prior consent of both the host-country supervisory authority and the bank's and, if different, the banking group's home-country supervisory authority.

3. Supervisory authorities should possess the right to gather information from cross-border banking establishments of the banks or banking groups for which they are the home-country supervisor.

4. If a host country authority determines that any one of the foregoing minimum standards is not met to its satisfaction, that authority could impose restrictive measures necessary to satisfy its prudential concerns consistent with these minimum standards, including the prohibition of the creation of banking establishments.

B. Current Status of Best Practices

232. This section discusses contacts and cooperation between a home and a single host supervisor based on the principles mentioned above.

Location of the licensing and lead supervisory authority

233. A **home country** supervisory authority is responsible for supervising the **global operations** of a bank or banking group, on the basis of **consolidated** and verifiable financial and prudential information. This approach encompasses not only a bank holding company or parent bank's direct branches and subsidiaries, but also includes any significant nonbank companies and financial affiliates.

234. The **home country should also be the location of the senior management** and the bulk (the majority of the consolidated balance sheet total) of a bank's business. If the majority of the activities appear to be conducted elsewhere, it would become difficult for the home

[149]See Basle Committee, "The Supervision of Cross-Border Banking", (Basle: Bank for International Settlements, 1996). Also included in the Basle Committee "Compendium of Documents."

supervisor to fulfil its obligations, and arrangements should be made with another country involved to take on the role of home supervisor. The case of BCCI, where the licensing authorities for the two parent banks could only could supervise a very minor part of the group's activities, as the bulk was conducted in other jurisdictions, has illustrated the necessity of this approach.

Licensing of internationally active banks

235. Home and host authorities should both give their **explicit permission for the setting up of an establishment abroad.**[150] The home authority should be able to refuse the establishment of a bank in a suspect, or under regulated jurisdiction. In addition to applying normal licensing procedure to a foreign bank, home and host country authorities should also consider the bank's and banking group's organization and operating procedures for the management of risks, internal controls and audit, both on a local and cross border basis. In judging these criteria, a host-country authority should be particularly concerned with the level of support that the head office or parent is capable of providing to the proposed establishment.

236. Before granting consent to the establishment of a cross-border establishment, both the home and host authorities should each **review their supervisory responsibilities** with respect to the establishment. If either of the authorities has any concerns about the division of responsibilities, then that authority has the responsibility to initiate consultations with the other authority so that they reach an explicit understanding on which authority is in the best position to take primary responsibility either generally or in respect of specific activities. A similar review should be undertaken by both authorities if there is a significant change in the bank's or banking group's activities or structure.

International implementation of prudential standards

237. The home country supervisory authority has responsibility for supervising the bank or banking group on a **consolidated basis, both domestically as well as internationally.** The home supervisor will also need to take account of the fact that capital cannot always easily be moved from one part of a banking group to another across international borders. Host countries are primarily responsible for the liquidity of a foreign establishment, since they will be better equipped to assess liquidity as a function of local market conditions and practices, and the establishment's position in the market.[151] But they will also be responsible for the solvency and supervision of subsidiaries. The Basle Concordat and subsequent amendments

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[150] See the Basle Committee "Minimum standards for the supervision of international banking groups and their cross-border establishments," (1992).

[151] See the Basle Committee's "Principles for the supervision of banks' foreign establishments," (1983).

and additions sets out the respective responsibilities of host and home authorities. Host authorities are responsible for the foreign bank establishments in their territory, and home country authorities are responsible for these establishments as parts of larger scale activities of banks under their supervision. Notwithstanding a certain division of labor, home and host authorities need to be in close contact and cooperate effectively.

Cross-border supervisory information

238. Home country supervisors have the right to **gather information from their cross-border banking establishments**. Host authorities should be able to obtain any necessary information from the home authority. This ability to gather information should be a condition for giving consent for the cross-border establishment of a bank, although appropriate safeguards for confidentiality are necessary. Any undue impediments in the home and the host country in the area of bank secrecy and confidentiality to the exchange of supervisory information between banking supervisory authorities,[152] should be removed. At the same time, legal arrangements need to be in place to safeguard the information that has been exchanged, especially relating to depositors', creditors', or investors' names, against disclosure to third parties. Local supervisory authorities should provide access to the local establishment of a bank to auditors of the head office or parent corporation, and be willing to discuss the affairs of the local establishment with the auditor.

239. The information to be shared should be both **quantitative and qualitative** aspects, including balance sheets, income or profit and loss accounts, information on shareholders and management, internal control systems, internal audit, external auditors' reports, prudential reports, and any other information that can be considered necessary for the proper exercise of supervision.[153] The information should permit the supervisors to calculate the bank's (or banking group's) capital adequacy ratios, large exposures or legal lending limits and funding and deposit concentrations on a consolidated basis. Even if from an accounting point of view full consolidation is technically not possible, the home and host supervisors should be able to verify the network of the bank's other affiliations or branches, financial or nonfinancial, as well as the transactions between these entities. Home and host authorities will need to be aware that prudential standards and supervisory practices may differ between countries.

240. Information on individual clients of a bank will typically have the highest degree of confidentiality protection. Such information will be required when assessing asset quality and

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[152] In order to supervise financial conglomerates effectively, barriers to the exchange of information between supervisory authorities over different financial sectors, domestically and internationally, should also be removed, subject to basic safeguards against disclosure to third parties.

[153] See Chapter III.B for a complete discussion of the information requirements for supervisors.

credit files may need to be examined. However, when a supervisor detects a **serious crime** during an inspection or analysis of off-site data, law enforcement agencies, as well as the supervisors in other countries involved should be informed as quickly as possible. Information on substantial changes in strategy, ownership, financial situation, or any problems in establishments abroad, head offices or parent banks should be communicated immediately to the other supervisory authorities involved.

Cross-border inspections

241. Authorities of the host state should **permit on-site inspections** by the home supervisor of a prudential nature[154] of establishments of internationally active banks within its jurisdiction. Together with the free flow of data, such inspections are a necessary corollary of effective consolidated supervision.

242. The conduct of **on-site inspections on the territory of another state** requires the consent of the country receiving the inspection team. Any legal barriers against such on-site inspections would need to be removed, for instance by concluding agreements between countries on the conduct of such inspections. Such agreements should preferably be multilateral in the case of banks active in several jurisdictions. If legal impediments exist in the interim, host supervisors should be willing to cooperate with any home supervisor that wishes to make an inspection to the fullest extent possible, within the limits of their laws. This can be facilitated by allowing the host supervisor the option to accompany the home supervisor throughout the inspection.

243. Operational aspects of cross-border inspections would typically need to be agreed upon in advance by both authorities. For this, **standardized arrangements** could be made between the supervisory authorities.[155] The findings of inspections should be shared between the supervisory authorities of both countries, as well as with the institution involved.

Supervisory action against establishments abroad

244. When inspections or other information would indicate the need for remedial or punitive action, this may be complicated by **differences in the legal arrangements**. Supervisory authorities in different countries should therefore conclude arrangements to make

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[154] In some countries, on-site inspections are used to verify compliance with non-prudential rules and regulations, such as taxation laws; inspections teams often include, e.g., investigative staff of taxation authorities, laws enforcement agencies, etc.

[155] See for instance the supervisory arrangements between the United States and Germany; Office of the Comptroller of the Currency (1996)

supervisory action in the other state possible, should the need arise. These arrangements could also include providing assistance in accessing local non-supervisory information, e.g., on the legal system, on shareholders' activities, in obtaining good legal counsel, etc.

245. **Branches abroad are the responsibility of the head office**. Therefore, the home country supervisor can require the management at the head office to remedy deficiencies in the branches, and apply the full range of legal instruments against the head office to achieve this result. Subsidiaries should also be subject to consolidated supervision, but are subject to the jurisdiction of the host state. The parent bank is likely to have considerable influence, and its home supervisor may use this influence to induce improvements.

Information on supervisory systems and structures

246. A host state should be able to ascertain whether the home state can "**capably perform home country consolidated supervision,**"[156] as a condition for permitting an establishment of a foreign bank entry to its territory. If the host supervisory authority is in any doubt in this respect, it should either refuse entry, or stipulate that the establishment shall be supervised on a strict "stand-alone" basis. Host and home authority should in any case be well aware of each other's supervisory systems and practices. The supervisory authorities of both states should exchange complete information on each other's banking laws, the scope of their respective authorities, and prudential regulations, applicable to the establishment on their territory. The supervisory authority should have adequate powers to obtain the necessary information, including regular financial reports and prudential reports. Quantity and quality of available resources to supervise the foreign operation should be assessed, as well as supervisory techniques, frequency of inspections, etc. These items should provide the basis for a judgement as to whether the supervisory authority is capable of performing consolidated supervision. It is also important to establish the track record of the other supervisory authority in taking effective supervisory action against banks, especially those with establishments abroad.

247. To facilitate the process a **system of routine personal contacts** should be set up between supervisors of the host and home countries, including the exchange of names, addresses, information on language skills, etc. Such information is of crucial importance for building a good and effective working relationship between both authorities, and for taking action when necessary. It will greatly facilitate many of the aspects of cross-border supervision as described above.

[156] See the Basle Committee "Minimum standards for the supervision of international banking groups and their cross-border establishments (1992)."

"Shell banks" and parallel owned banks[157]

248. The authority that licenses a so-called "shell bank," defined here as a loan generation or booking office, licensed or registered in one center, but effectively controlled or managed from another jurisdiction, has **responsibility for supervising the shell bank**. To be effective, no shell bank should be licensed if the head office in another jurisdiction is not subject to adequate banking supervision on a consolidated basis. When a license is requested for a shell bank, the supervisory authority needs to establish contact with the home supervisor of the bank or its parent bank, and ascertain whether permission has been granted to open the office abroad. Only when all necessary information on the bank, and on the quality of home country supervision, is obtained and found satisfactory, can the application be approved.

249. The home supervisor needs to be allowed to **inspect the books of the shell bank** wherever they are kept, and in whatever form, in order to establish whether banking activities are undertaken, or whether the risks are insufficiently controlled by the head office. If inspection by the home supervisor will not be allowed, it can not authorize the shell bank to be established. If subsequent to its opening, the home supervisor is unable to satisfactorily inspect the books, the "shell-bank" must be closed.

250. Parallel-owned banks, where a bank in one jurisdiction is under the same non-bank ownership as a bank in another jurisdiction, are more problematical and need to be kept under close scrutiny. If the non-bank owner has as its sole activity the ownership of one or more banks, the **owner ought also to be subject to the consolidated banking supervision** of a single banking supervisory authority, notwithstanding the separate responsibility of the supervisory authorities in the respective individual countries. In the absence of such an arrangement it will be necessary for the respective supervisors to prevent sources of contagion, e.g. by particularly rigorous connected lending rules.

International financial conglomerates

251. The problems illustrated above become even more salient in the case of an internationally active financial conglomerate. Supervisors over conglomerates active in several financial sectors need to **establish close contacts and make practical arrangements** for the exercise of supervision. A financial group, incorporating banking, securities and insurance subsidiaries and other financial intermediaries, can be subject to three or more different regulators and regulatory regimes. At the domestic level this already poses significant problems of coordination, information, and compliance with prudential regulations. These problems are compounded at the international level, where the problem of coordination,

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[157]See Basle Committee (1996) "The Supervision of Cross-Border Banking".

information and compliance potentially involves several regulators for each country where the conglomerate is active. In such cases, some countries have found it useful to designate lead regulators to carry out a coordinating role.

252. The technical issues that need to be addressed in the context of international financial conglomerates have been enumerated in the Joint Forum's mandate, and consist of: (1) the supervision of financial conglomerates on a group-wide perspective; (2) techniques for assessing the adequacy of capital of financial conglomerates; (3) supervisors' ability to check on fit and proper standards of managers and their ability to ensure that shareholders meet adequate standards; (4) the supervisory approach to participations of less than 100 percent in entities within financial conglomerates; (5) the supervisory approach to large exposures and to intra-group exposures within financial conglomerates; (6) the supervisors' ability to intervene in structures that impair effective supervision.

International bank liquidation[158]

253. When a bank, which has a **branch in another country,** is closed, liquidated or declared insolvent, the supervisory authority in the country where the branch is established must be immediately informed by the home supervisory authority. The host authority would then immediately close the branch. Any additional liabilities incurred by the branch, for instance, would fall within the estate of the closed bank. Subsidiaries are legally separate from the parent bank. Their assets and liabilities in theory remain unchanged when the parent bank closes. However, there is an increased risk of uploading or downloading assets and liabilities between the closed parent and the subsidiary, which could damage the subsidiary's depositors and other creditors.

254. Ideally, bank liquidation takes place on the basis of a single set of rules. In practice, **international bank insolvencies** are extremely complicated, as some countries follow the separate entity approach and are able to place their depositors and creditors before those of other countries, irrespective of liquidation law in the other country, whereas other countries follow the single entity approach, which considers the bank as a whole, and gives equal treatment to all creditors wherever their domicile and whether their claim is on a domestic or foreign branch. These are issues that cannot be solved by supervisors, even when the outcome is relevant to the proper execution of their task. In the light of the greater internationalization of banking activities, and the potential international impact of such liquidations, further international harmonization of insolvency rules for financial institutions is desirable.[159] Work on international insolvency law is being undertaken by the United Nations

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[158]The "Core Principles for Effective Banking Supervision" does not address international bank liquidation.

[159]See Basle Committee, *"Case study of the insolvency and liquidation of a multinational*
(continued...)

Commission on International Trade Law (UNCITRAL), and recently a draft document of the Group of Thirty was issued on international insolvencies of financial institutions.[160] It is essential that supervisory authorities keep each other closely informed on bank insolvencies and liquidations, and provide all possible assistance in helping foreign supervisors have access to the proceedings in their countries.

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[159](...continued)
bank," (Basle: Bank for International Settlements, October 1993), which discussed problems associated with the liquidation of BCCI.

[160]"International Insolvencies in the Financial Sector," Discussion Draft, in cooperation with INSOL International (Washington: Group of Thirty, 1996). The EU has for many years attempted to reach agreement on rules for the intervention in, and liquidation, of banks.

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Core Principles

for

Effective Banking Supervision

Consultative paper issued by the
Basle Committee on Banking Supervision

Basle
April 1997

Table of Contents

Core Principles for Effective Banking Supervision (Basle Core Principles)

1. Weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally. The need to **improve the strength of financial systems** has attracted growing international concern. The Communiqué issued at the close of the Lyon G-7 Summit in June 1996 called for action in this domain. Numerous official bodies have recently been examining ways to strengthen financial stability throughout the world and notably in the emerging market economies.

2. The Basle Committee on Banking Supervision[1] has been working in this field for many years, both directly and through its many contacts with banking supervisors in every part of the world. In the last year it has been examining how best to expand its efforts aimed at strengthening prudential supervision in all countries by building on its relationships with countries outside the G-10 as well as on its earlier work to enhance prudential supervision in its member countries. In particular, the Committee has prepared two documents for release:

- a comprehensive set of **Core Principles** for effective banking supervision (The Basle Core Principles) applicable in both G-10 and non-G-10 countries (attached); and,
- a **Compendium** of the existing Basle Committee recommendations, guidelines and standards (to be published separately).

Both documents have been endorsed by the G-10 central bank Governors. They have been submitted to the G-7 and G-10 Finance Ministers in preparation for the Denver Summit in the hope that they will provide a useful mechanism for strengthening financial stability in all countries.

3. In developing the Principles, the Basle Committee has worked closely with **non-G-10 supervisory authorities**. The document has been prepared in a group containing representatives from the Basle Committee and from Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Eight other countries (Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore) were also closely associated with the work. The drafting of the Principles benefited moreover from broad consultation with a larger group of

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1 The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is located.

individual supervisors, both directly and through the regional supervisory groups. The IMF and the World Bank have seen and commented on the work at various intermediate stages.

4. The Basle Core Principles are being **released for consultation**. Comments are invited from non-G-10 supervisory authorities in particular, but also from banks and other interested parties. Private sector commenters are asked to address their remarks to the general framework of the Principles and not to specific points relating to their own jurisdictions. Such comments should be addressed to national supervisors who are invited to transmit them to the Basle Committee. All comments must be received by the Committee no later than 16th June 1997.

5. At the end of the comment period, the document will be finalised, hopefully in advance of the IMF and World Bank annual meetings in Hong Kong in late September 1997. Advantage will be taken of the opportunity provided by that forum to present and explain the Principles to a global audience. Subsequently, the Basle Committee will be ready to play a role, together with other interested organisations, in monitoring the progress made by individual countries in implementing the Principles.

6. The Basle Core Principles comprise **twenty-five basic Principles** that need to be in place for a supervisory system to be effective. The Principles relate to:

Preconditions for effective banking supervision - Principle 1
Licensing and structure - Principles 2 to 5
Prudential regulations and requirements - Principles 6 to 15
Methods of ongoing banking supervision - Principles 16 to 20
Information requirements - Principle 21
Formal powers of supervisors - Principle 22, and
Cross-border banking - Principles 23 to 25.

In addition to the Principles themselves, the document contains explanations of the various methods supervisors can use to implement them.

7. National agencies should apply the Principles in the supervision of all banks within their jurisdictions. The Principles are **minimum requirements** and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries.

8. The Basle Core Principles are intended to serve as a basic reference for **supervisory and other public authorities in all countries and internationally**. It will be for national supervisory authorities, many of which are actively seeking to strengthen their current supervisory regime, to use the attached document to initiate a programme designed to address any deficiencies as quickly as is practical within their legal authority. It is suggested that the IMF, the World Bank and other interested organisations use the Principles in assisting

individual countries to strengthen their supervisory arrangements in connection with work aimed at promoting overall macroeconomic and financial stability.

9. Supervisory authorities throughout the world will be encouraged to make a **formal endorsement** of the final version of the Basle Core Principles. The members of the Basle Committee and the fifteen countries that have participated in their drafting all agree with the content of the document.

10. The chairpersons of the **regional supervisory groups**[2] are supportive of the Basle Committee's efforts. Most of these groups plan to discuss the Core Principles at meetings to be held over the next few months. They will all actively promote the consultation process among their membership and it is hoped that these groups will be in a position to confirm their general support by the time the comment process has been concluded. Discussions are also in progress to define the role the regional groups will play in promoting the formal endorsement of the Principles and in monitoring implementation by their members.

11. **Implementation** of the Core Principles will involve carrying out a review of existing supervisory arrangements and, where these are inconsistent in any material respect with the Principles, establishing a time frame for addressing the deficiencies. The Principles have been designed to be verifiable by supervisors, their regional groups, and the market at large. Implementation of the Principles will be surveyed by the Basle Committee and reviewed at the International Conference of Banking Supervisors in October 1998 and bi-annually thereafter.

12. The Basle Committee believes that achieving consistency with the Core Principles by every country will be a significant step in the process of improving financial stability domestically and internationally. The speed with which this objective will be achieved will vary. In many countries, substantive **changes in the legislative framework** and in the powers of supervisors will be necessary because many supervisory authorities do not at present have the statutory authority to implement all of the Principles. In such cases, the Basle Committee believes it is essential that national legislators give urgent consideration to the changes necessary to ensure that the Principles can be applied in all material respects. The need for new legislation will be taken into account by the Basle Committee in monitoring progress towards implementation.

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2 Arab Committee on Banking Supervision, Caribbean Banking Supervisors Group, Association of Banking Supervisory Authorities of Latin America and the Caribbean, Eastern and Southern Africa Banking Supervisors Group, Group of Banking Supervisors from Central and Eastern European Countries, Gulf Cooperation Council Banking Supervisors' Committee, Offshore Group of Banking Supervisors, Regional Supervisory Group of Central Asia and Transcaucasia, SEANZA Forum of Banking Supervisors, Committee of Banking Supervisors in West and Central Africa.

13. **The Basle Committee** will continue to pursue its standard-setting activities in key risk areas and in key elements of banking supervision as it has done in documents such as those reproduced in the Compendium. The Basle Core Principles will serve as a reference point for future work to be done by the Committee and, where appropriate, in cooperation with other organisations. The Committee stands ready to encourage work at the national level to implement the Principles in conjunction with other supervisory bodies and interested parties. Finally, the Committee is committed to strengthening its interaction with supervisors from non-G-10 countries and maintaining its considerable investment in technical assistance and training.

LIST OF CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Licensing and Structure

2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the bank's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Prudential Regulations and Requirements

6. Banking supervisors must set minimum capital requirements for banks that reflect the risks that the banks undertake, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basle Capital Accord.

7. An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

8. Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

9. Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

10. In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

11. Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate reserves against such risks.

12. Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

13. Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Methods of Ongoing Banking Supervision

16. An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

17. Banking supervisors must have regular contact with bank management and thorough understanding of the institution's operations.

18. Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

19. Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

20. An essential element of banking supervision is the ability of the supervisors to supervise the banking organisation on a consolidated basis.

Information Requirements

21. Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Formal Powers of Supervisors

22. Banking supervisors must have at their disposal adequate supervisory measures to bring about corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way.

Cross-border Banking

23. Banking supervisors must practice global consolidated supervision, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by banking organisations worldwide, primarily at their foreign branches and subsidiaries.

24. A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

25. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

SECTION I: INTRODUCTION

Effective supervision of banking institutions is an essential component of a strong economic environment in that the banking system plays a central role in making payments and mobilising and distributing savings. The task of supervision is to ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business. Strong and effective banking supervision provides a public good that may not be fully provided in the marketplace and, along with effective macroeconomic policy, is critical to financial stability in any country. While the cost of banking supervision is indeed high, the cost of poor supervision has proved to be even higher.

In drawing up these core principles for effective banking supervision the following precepts are fundamental:

- the key objective of supervision is to reduce the risk of loss to depositors and other creditors, and to maintain confidence in the financial system;
- supervisors should encourage and pursue market discipline by encouraging good corporate governance (through an appropriate structure and set of responsibilities for a bank's board of directors and senior management) and enhancing market transparency and surveillance;
- in order to carry out its tasks effectively, a supervisor must have operational independence, the means and powers to gather information both on and off site, and the authority to enforce its decisions;
- supervisors must understand the nature of the business undertaken by banks and ensure to the extent possible that the risks incurred by banks are being adequately managed;
- effective banking supervision requires that the risk profile of individual banks be assessed and supervisory resources allocated accordingly;
- supervisors must ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management, and effective control systems and accounting records; and
- close cooperation with other supervisors is essential and particularly so where the operations of banks cross national boundaries.

Banking supervision should foster an efficient and competitive banking system that is responsive to the public's need for good quality financial services at a reasonable cost.

Generally, it should be recognised that there is a trade-off between the level of protection that supervision provides and the cost of financial intermediation. The lower the tolerance of risk to banks and the financial system, the more intrusive and costly supervision is likely to be, eventually having an adverse effect on innovation and resource allocation.

Supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are a part of risk-taking. The way in which failures are handled, and their costs borne, is in large part a political matter involving decisions on whether, and the extent to which, public funds should be committed to supporting the banking system. Such matters cannot therefore always be entirely the responsibility of banking supervisors; however, supervisors should have in place adequate arrangements for resolving problem bank situations.

There are certain infrastructure elements that are required to support effective supervision. Where such elements do not exist, supervisors should seek to persuade government to put them in place (and may have a role in designing and developing them). These elements are discussed in Section II.

In some countries responsibility for licensing banks is separate from the process of ongoing supervision. It is clearly essential that, wherever the responsibility lies, the licensing process establishes the same high standards as the process of ongoing supervision which is the main focus of this paper. Section III therefore discusses some principles and issues that should be addressed in the licensing process.

The core principles of banking supervision set out above and expanded in Sections III-VI of this document will provide the foundation necessary to achieve a sound supervisory system. Local characteristics will need to be taken into account in the specific way in which these standards are implemented. These standards are necessary but may not be sufficient, on their own, in all situations. Supervisory systems should take into account the nature of and risks involved in the local banking market as well as more generally the local infrastructure. Each country should therefore consider to what extent it needs to supplement these standards with additional requirements to address particular risks and general conditions prevailing in its own market. Furthermore, 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 new trends or developments. A sufficiently flexible legislative framework is necessary to enable them to do this.

SECTION II: PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

Banking supervision is only part of wider arrangements that are needed to promote financial stability. These arrangements include:

1. sound and sustainable macro-economic policies;
2. a well developed public infrastructure;
3. effective market discipline;
4. procedures for efficient resolution of problems in banks; and
5. mechanisms for providing an appropriate level of systemic protection (or public safety net).

1. *Providing sound and sustainable macro-economic policies* are not within the competence of banking supervisors. Supervisors, however, will need to react if they perceive that existing policies are undermining the safety and soundness of the banking system. In the absence of sound macro-economic policies, banking supervisors will be faced with a virtually impossible task. Therefore, sound macro-economic policies must be the foundation of a stable financial system.

2. *A well developed public infrastructure* needs to cover the following facilities, which, if not adequately provided, can significantly contribute to the destabilisation of financial systems:

- a system of business laws including corporate, bankruptcy, contract, consumer protection and private property laws, that is consistently enforced and provides a mechanism for fair resolution of disputes;

- comprehensive and well-defined accounting principles and rules that command wide international acceptance;

- a system of independent audits for companies of significant size so that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work;

- effective banking supervision (see below);

- well-defined rules governing, and adequate supervision of, other capital markets and, where appropriate, their participants; and,

- a secure and efficient payment and clearing system for the settlement of financial transactions where counterparty risks are controlled.

3. *Effective market discipline* depends on an adequate flow of information to market participants, appropriate financial incentives to reward well managed institutions and arrangements that ensure that investors are not insulated from the consequences of their decisions. Among the issues to be addressed are corporate governance and ensuring that accurate, meaningful, transparent and timely information is provided by borrowers to investors and creditors.

Market signals can be distorted and discipline undermined if governments seek to influence or override commercial decisions, particularly lending decisions, to achieve public policy objectives. In these circumstances, it is important that if guarantees are provided for such lending, they are disclosed and arrangements are made to compensate financial institutions when policy loans cease to perform.

4. Sufficiently flexible powers are necessary in order to effect an *efficient resolution of problems in banks*. Where problems are remediable, supervisors will normally seek to identify and implement solutions that fully address their concerns; where they are not, the prompt and orderly exit of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system. Forebearance, whether or not the result of political pressure, normally leads to worsening problems and higher resolution costs. The supervisory agency should be responsible for, or assist in, the orderly exit of problem banks in order to ensure that depositors are repaid to the fullest extent possible from the resources of the bank (supplemented by any applicable deposit insurance)[3] and ahead of shareholders, subordinated debt holders and other connected parties.

In some cases, the best interests of depositors may be served by some form of restructuring, possibly takeover by a stronger institution or injection of new capital or shareholders. Supervisors may be able to facilitate such outcomes. It is essential that the end result fully meets all supervisory requirements, that it is realistically achievable in a short and determinate timeframe, and that, in the interim, depositors are protected.

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3 As deposit insurance interacts with banking supervision, some basic principles are discussed in Appendix II.

5. Deciding on the *appropriate level of systemic protection* is by and large a policy question to be taken by the relevant authorities (including the central bank), particularly where it may result in a commitment of public funds. Supervisors will also normally have a role to play because of their in-depth knowledge of the institutions involved. In order to preserve the operational independence of supervisors, it is important to draw a clear distinction between this systemic protection (or safety net) role and day-to-day supervision of solvent institutions. In handling systemic issues, it will be necessary to address, on the one hand, risks to confidence in the financial system and contagion to otherwise sound institutions, and, on the other hand, the need to minimise the distortion to market signals and discipline. Deposit insurance arrangements, where they exist, may also be triggered.

Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

This standard requires the following components to be in place:

- a clear, achievable and consistent framework of responsibilities and objectives set by the government for (each of) the supervisor(s) involved, but with operational independence to pursue them free from political pressure and with accountability for achieving them;

- adequate resources to meet the objectives set, provided on terms that do not undermine the autonomy and independence of the supervisory agency;

- a framework of banking law that sets out minimum standards that banks must meet; allows supervisors sufficient flexibility to set prudential rules administratively, where necessary, to achieve the objectives set as well as to utilise qualitative judgement; provides powers to gather information; and, gives supervisors power to enforce a range of penalties that may be applied when prudential requirements are not being met (including powers to remove individuals, invoke sanctions and revoke licences);

- protection (normally in law) from personal and institutional liability for supervisory actions taken in good faith in the course of performing supervisory duties; and,

- a system of interagency cooperation and sharing of relevant information among the various official agencies, both domestic and foreign, responsible for the safety and soundness of the financial system; this cooperation should be supported by arrangements for protecting the confidentiality of supervisory information and ensuring that it is used only for purposes related to the effective supervision of the institutions concerned.

SECTION III: LICENSING PROCESS AND APPROVAL FOR CHANGES IN STRUCTURE

Principle 2. The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word "bank" in names should be controlled as far as possible.

Principle 3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the bank's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

In order to facilitate a healthy financial system, and to define precisely the population of institutions to be supervised, the arrangements for licensing banking institutions and the scope of activities governed by licences should be clearly defined. In particular, at a minimum, the activity of retail deposit-taking must be reserved for institutions that are licensed and subject to supervision as banks. The term "bank" must be clearly defined and the use of the word "bank"[4] in names should be controlled to the extent possible in those circumstances where the general public might be misled by unlicensed, unsupervised institutions implying otherwise by the use of "bank" in their titles.

By basing banking supervision on a system of licensing (or chartering) deposit-taking institutions (and, where appropriate, other types of financial institutions), the supervisors will have a means of identifying the population to be supervised and entry to the banking system will be controlled. The licensing authority must determine that new banking organisations have suitable shareholders, adequate financial strength, a legal structure in line with its operational structure, and management with sufficient expertise and integrity to operate the bank in a sound and prudent manner. It is important that the criteria for issuing licences are consistent with those applied in ongoing supervision so that they can provide one of the bases for withdrawing authorisation when an established institution no longer meets the criteria. Where the licensing and supervisory authorities are different, it is essential that they cooperate closely in the licensing process and that the supervisory authority has a legal right to have its views considered by the licensing authority. Clear and objective criteria also reduce the potential for political interference in the licensing process. Although the licensing

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4 This includes any derivations of the word "bank", including "banking".

process cannot guarantee that a bank will be well run after it opens, it can be an effective method for reducing the number of unstable institutions that enter the banking system. Licensing regulations, as well as supervisory tools, should be designed to limit the number of bank failures and the amount of depositor losses without inhibiting the efficiency and competitiveness of the banking industry by blocking entry to it. Both elements are necessary to maintain public confidence in the banking system.

Having established strict criteria for reviewing a banking licence application, the licensing authority must have the right to reject applications if it cannot be satisfied that the criteria set are met. The licensing process, at a minimum, should consist of an assessment of the bank's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital adequacy; when the proposed owner is a foreign bank, prior consent of its home country supervisor should be obtained.

A. Ownership structure

Supervisors must be able to assess the ownership structure of banking organisations. This assessment should include the bank's direct and indirect controlling and major[5] direct or indirect shareholders. This assessment should review the controlling shareholders' past banking and non-banking business ventures and their integrity and standing in the business community, as well as the financial strength of all major shareholders and their ability to provide further financial support should it be needed. As part of the process of checking integrity and standing, the supervisor should determine the source of the initial capital to be invested.

Where a bank will be part of a larger organisation, licensing and supervisory authorities must determine that the ownership and organisational structure will not be a source of weakness and will minimise the risk to depositors of contagion from the activities conducted by other entities within the larger organisation. The other interests of the bank's major shareholders must be reviewed and the financial condition of these related entities assessed. The bank should not be used as a captive source of finance for its owners. When evaluating the corporate affiliations and structure of the proposed bank within a conglomerate, the licensing and supervisory authorities must determine that there will be sufficient transparency to permit them to identify the individuals responsible for the sound operations of the bank and to ensure that these individuals have the autonomy within the conglomerate structure to respond quickly to supervisory recommendations and requirements.

5 In many countries, a "major" shareholder is defined as holding 10% or more of a bank's equity capital.

Finally, the licensing and supervisory authorities must have the authority to prevent corporate affiliations or structures that hinder the effective supervision of banks. These can include structures where material parts are in jurisdictions where secrecy laws or inadequate financial supervision are significant obstacles and structures where the same owners control banks with parallel structures which cannot be subjected to consolidated supervision because there is no common corporate link.

B. Operating plan, systems of control and internal organisation

Another element to review during the licensing process is the operations and strategies proposed for the bank. The operating plan should describe and analyse the market area from which the bank expects to draw the majority of its business and establish a strategy for the bank's ongoing operations. The application should also describe how the bank will be organised and controlled internally. The licensing agency should determine if these arrangements are consistent with the proposed strategy and must also determine whether adequate internal policies and procedures have been developed and adequate resources deployed. This should include determining that appropriate corporate governance will be in place (a management structure with clear accountability, a board of directors with ability to provide an independent check on management, and independent audit and compliance functions) and that the "four eyes" principle (segregation of various functions, cross-checking, dual control of assets, double signatures, etc.) will be followed. It is essential to determine that the legal and operational structures will not inhibit supervision on either a solo or consolidated basis and that the supervisor will have adequate access to management and information. For this reason, supervisors should not grant a licence to a bank when the head office will be located outside its jurisdiction unless the supervisor is assured that it will have adequate access to management and information. (See Section E below for licensing of banks incorporated abroad.)

C. Fit and proper test for directors and senior managers

A key aspect of the licensing process is an evaluation of the competence, integrity and qualifications of proposed management, including the board of directors. The licensing agency should obtain the necessary information about the proposed directors and senior managers to consider individually and collectively their banking experience, other business experience, personal integrity and relevant skill. This evaluation of management should involve background checks on whether previous activities, including regulatory or judicial judgements, raise doubts concerning their competence, sound judgement, or honesty. It is critical that the bank's proposed management team includes a substantial number of individuals with a proven track record in banking. Supervisors should have the authority to require notification of subsequent changes in directors and senior management and to prevent such appointments if they are deemed to be detrimental to the interests of depositors.

D. **Financial projections including capital**

The licensing agency should review *pro forma* financial statements and projections for the proposed bank. The review should determine whether the projections are consistent and realistic in view of the bank's proposed strategic plan and whether the bank will have sufficient capital to support this strategy, especially in light of start-up costs and possible operational losses in the early stages. In many countries, licensing agencies have established a minimum initial capital amount. The licensing agency should also consider the ability of shareholders to supply additional support, if needed, once the bank has commenced activities. If there will be a corporate shareholder with a significant holding, an assessment of the financial condition of the corporate parent should be made, including its capital strength.

E. **Prior approval from the home country supervisor when the proposed owner is a foreign bank**

When a foreign bank, subsidiary of a foreign banking group, or a foreign non-banking financial institution (subject to a supervisory authority) proposes to establish a local bank or branch office, the licensing authority should consider whether the Basle Minimum Standards[6] are met and in particular the licence should not normally be approved until the consent of the home country supervisor of the bank or banking group has been obtained. The host authority should also consider whether the home country supervisor capably performs its supervisory task on a consolidated basis. In assessing whether capable consolidated supervision is provided, the host licensing authority should consider not only the nature and scope of the home country supervisory regime but also whether the structure of the applicant or its group is such as to not inhibit effective supervision by the home and host country supervisory authorities.

F. **Transfer of a bank's shares**

Principle 4. Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

In addition to licensing new banks, banking supervisors should be notified of any future significant direct or indirect investment in the bank or any increases or other changes in ownership over a particular threshold and should have the power to block such investments or prevent the exercise of voting rights in respect of such investments if they do not meet criteria comparable to those used for approving new banks. Notifications are often required

6 See "*Minimum Standards for the supervision of international banking groups and their cross-border establishments*" - Volume III of the Compendium.

for ownership or voting control involving established percentages of a bank's outstanding shares.[7] The threshold for approval of significant ownership changes may be higher than that for notification.

G. Major acquisitions or investments by a bank

Principle 5. Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

In many countries, once a bank has been licensed, it may conduct any activities normally permissible for banks or any range of activities specified in the banking licence. Consequently, certain acquisitions or investments may be automatically permissible if they comply with certain limits set by the supervisors or by banking law or regulation.

In certain circumstances, supervisors require banks to provide notice or obtain explicit permission before making certain acquisitions or investments. In these instances, supervisors need to determine if the bank has both the financial and managerial resources to make the acquisition and may need to consider also whether the investment is permissible under existing banking laws and regulations. The supervisor must clearly define what types and amounts of investments need prior approval and for what cases notification is sufficient. Notification after the fact is most appropriate in those instances where the activity is closely related to banking and the investment is small relative to the bank's total capital.

7 These established percentages typically range between 5 and 10%.

SECTION IV: ARRANGEMENTS FOR ONGOING BANKING SUPERVISION

A. Risks in Banking

Banking, by its nature, entails taking a wide array of risks. Banking supervisors need to understand these risks and be satisfied that banks are adequately measuring and managing them. The key risks faced by banks are discussed below.

Credit risk

The extension of loans is the primary activity of most banks. Lending activities require banks to make judgements related to the creditworthiness of borrowers. These judgements do not always prove to be accurate and the creditworthiness of a borrower may decline over time due to various factors. Consequently, a major risk that banks face is credit risk or the failure of a counterparty to perform according to a contractual arrangement. This risk applies not only to loans but to other on- and off-balance sheet exposures such as guarantees, acceptances and securities investments. Serious banking problems have arisen from the failure of banks to recognise impaired assets, to create reserves for writing off these assets, and to suspend recognition of interest income when appropriate.

Large exposures to a single borrower, or to a group of related borrowers are a common cause of banking problems in that they represent a credit risk concentration. Large concentrations can also arise with respect to particular industries, economic sectors, or geographical regions or by having sets of loans with other characteristics that make them vulnerable to the same economic factors (e.g., highly-leveraged transactions).

Connected lending - the extension of credit to individuals or firms connected to the bank through ownership or through the ability to exert direct or indirect control - if not properly controlled, can lead to significant problems because determinations regarding the creditworthiness of the borrower are not always made objectively. Connected parties include a bank's parent organisation, major shareholders, subsidiaries, affiliated companies, directors, and executive officers. Firms are also connected when they are controlled by the same family or group. In these, or in similar, circumstances, the connection can lead to preferential treatment in lending and thus greater risk of loan losses.

Country and transfer risk

In addition to the counterparty credit risk inherent in lending, international lending also includes country risk, which refers to risks associated with the economic, social and political environments of the borrower's home country. Country risk may be most apparent when lending to foreign governments or their agencies, since such lending is typically unsecured, but is important to consider when making any foreign loan or investment, whether to public or private borrowers. There is also a component of country risk called "transfer risk" which arises when a borrower's obligation is not denominated in the local currency. The currency of the obligation may become unavailable to the borrower regardless of its particular financial condition.

Market risk

Banks face a risk of losses in on- and off-balance sheet positions arising from movements in market prices. Established accounting principles cause these risks to be typically most visible in a bank's trading activities, whether they involve debt or equity instruments, or foreign exchange or commodity positions. One specific element of market risk is foreign exchange risk. Banks act as "market-makers" in foreign exchange by quoting rates to their customers and by taking open positions in currencies. The risks inherent in foreign exchange business, particularly in running open foreign exchange positions, are increased during periods of instability in exchange rates.

Interest rate risk

Interest rate risk refers to the exposure of a bank's financial condition to adverse movements in interest rates. This risk impacts both the earnings of a bank and the economic value of its assets, liabilities and off-balance sheet instruments. Interest rate risk can arise in both the banking and trading book. The primary forms of interest rate risk to which banks are typically exposed are: (1) repricing risk, which arises from timing differences in the maturity (for fixed rate) and repricing (for floating rate) of bank assets, liabilities and off-balance sheet positions; (2) yield curve risk, which arises from changes in the slope and shape of the yield curve; (3) basis risk, which arises from imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics; and (4) optionality, which arises from the express or implied options imbedded in many bank assets, liabilities and off-balance sheet portfolios.

Although such risk is a normal part of banking, excessive interest rate risk can pose a significant threat to a bank's earnings and capital base. This issue is of growing importance in sophisticated financial markets where customers actively manage their interest rate exposure, but it is also a crucial factor in a system where interest rates are being deregulated.

Liquidity risk

Liquidity risk arises from the inability of a bank to accommodate decreases in liabilities or to fund increases in assets. When a bank has inadequate liquidity, it cannot obtain sufficient funds, either by increasing liabilities or by converting assets promptly, at a reasonable cost, thereby affecting profitability. In extreme cases, insufficient liquidity can lead to the insolvency of a bank.

Operational risk

The most important types of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way, for example, by its dealers, lending officers or other staff exceeding their authority or conducting business in an unethical or risky manner. Other aspects of operational risk include major failure of information technology systems or events such as major fires or other disasters.

Legal risk

Banks are subject to various forms of legal risk. This can include the risk that assets will turn out to be worth less or liabilities to be greater than expected because of inadequate or incorrect legal advice or documentation. In addition, existing laws may fail to resolve legal issues involving a bank; a court case involving a particular bank may have wider implications for banking business and involve costs to it and many or all other banks; and, laws affecting banks or other commercial enterprises may change. Banks are particularly susceptible to legal risks when entering new types of transactions and when the legal right of a counterparty to enter into a transaction is not established.

Reputational risk

Reputational risk arises from operational failures, failure to comply with relevant laws and regulations, or other sources. Reputational risk is particularly damaging for banks since the nature of their business requires maintaining the confidence of depositors, creditors and the general marketplace.

B. Development and Implementation of Prudential Regulations and Requirements

The risks inherent in banking must be recognised, monitored and controlled. Supervisors play a critical role in ensuring that bank management does this. An important part of the supervisory process is the authority of supervisors to develop and utilise prudential regulations and requirements to control these risks, including those covering capital adequacy, loan loss reserves, asset concentrations, liquidity, risk management and internal controls. These may be qualitative and/or quantitative requirements. Their purpose is to limit imprudent risk-taking by banks. These requirements should not supplant management decisions but rather impose minimum prudential standards to ensure that banks conduct their activities in an appropriate manner. The dynamic nature of banking requires that supervisors periodically assess their prudential requirements and evaluate the continued relevance of existing requirements as well as the need for new requirements.

1. Capital adequacy

Principle 6: Banking supervisors must set minimum capital requirements for banks that reflect the risks that the banks undertake, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basle Capital Accord.

Equity capital serves several purposes: it provides a permanent source of revenue for the shareholders and funding for the bank; it is available to bear risk and absorb losses; it provides a base for further growth; and it gives the shareholders reason to ensure that the bank is managed in a safe and sound manner. Minimum capital adequacy ratios are necessary to protect the interests of depositors, creditors and other stakeholders of the bank and to help supervisors pursue the overall stability of the banking industry. Supervisors must set minimum capital adequacy ratios and encourage banks to operate with capital in excess of the minimum. Supervisors should consider requiring higher than minimum capital ratios when it appears appropriate due to the particular risk profile of the bank or if there are uncertainties regarding the asset quality, risk concentrations or other adverse characteristics of a bank's financial condition. No bank, particularly one that is large or otherwise important to the country's financial system, should be allowed to operate with ratios below the minimum.

In 1988, the member countries of the Basle Committee on Banking Supervision agreed to a method of ensuring a bank's capital adequacy.[8] Many other countries have adopted the Capital Accord or something very close to it. The Accord addresses two important elements of a bank's activities: (1) different levels of credit risk inherent in its balance sheet and (2) off-balance sheet activities, which can represent a significant risk exposure.

The Accord defines what types of capital are acceptable for supervisory purposes and stresses the need for adequate levels of "core capital" (in the accord this capital is referred to as tier one capital) consisting of permanent shareholders' equity and disclosed reserves that are created or maintained by appropriations of retained earnings or other surplus (e.g. share premiums, retained profit, general reserves and reserves required by law). Disclosed reserves also include general funds that meet the following criteria: (1) allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential

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8 See "*International convergence of capital measurement and capital standards*" - Volume I of the Compendium.

tax liabilities; (2) the funds and movements into or out of them must be disclosed separately in the bank's published accounts; (3) the funds must be available to a bank to meet losses; and (4) losses cannot be charged directly to the funds but must be taken through the profit and loss account. The Accord also acknowledges other forms of supplementary capital (referred to as tier two capital), such as other forms of reserves and hybrid capital instruments that should be included within a system of capital measurement.

The Accord assigns risk weights to on- and off-balance sheet exposures according to broad categories of relative riskiness. The framework of weights has been kept as simple as possible with only five weights being used: 0, 10, 20, 50 and 100%.

The Accord sets minimum capital ratio requirements for internationally active banks of 4% tier one capital and 8% total (tier one plus tier two) capital in relation to risk-weighted assets. These requirements are applied to banks on a consolidated basis (and, at the option of the supervisor, also on a solo basis). It must be stressed that these ratios are considered a minimum standard.

2. Credit risk management

(i) Credit-granting standards and credit monitoring process

Principle 7: An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Supervisors need to ensure that the credit and investment function at individual banks is objective and grounded in sound principles. The maintenance of prudent written lending policies, loan approval and administration procedures, and appropriate loan documentation are essential to a bank's management of the lending function. Lending and investment activities must be based on prudent underwriting standards that are approved by the bank's board of directors and clearly communicated to the bank's lending officers and staff. It is also critical for supervisors to determine the extent to which the institution makes its credit decisions free of conflicting interests and inappropriate pressure from outside parties.

Banks must also have a well-developed process for ongoing monitoring of credit relationships, including the financial condition of significant borrowers. A key element of any management information system should be a data base that provides essential details on the condition of the loan portfolio, including internal loan grading and classifications.

(ii) Assessment of asset quality and adequacy of loan loss provisions and reserves

Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

Supervisors should assess a bank's policies regarding the periodic review of individual credits, asset classification and provisioning. They should be satisfied that these policies are being reviewed regularly and implemented consistently. Supervisors should also ensure that banks have a process in place for overseeing problem credits and collecting past due loans. When the level of problem credits at a bank is of concern to the supervisors, they must require the bank to strengthen its lending practices, credit-granting standards, and overall financial strength.

When guarantees or collateral are provided, the bank must have a mechanism in place for continually assessing the strength of these guarantees and appraising the worth of the collateral. Supervisors must also ensure that banks properly record and hold adequate capital against off-balance sheet exposures when they retain contingent risks.

(iii) Concentrations of risk and large exposures

Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Banking supervisors must set prudential limits to restrict bank exposures to single borrowers, groups of related borrowers and other significant risk concentrations.[9] These limits are usually expressed in terms of a percentage of bank capital and, although they vary, 25% of capital is typically the most that a bank or banking group may extend to a private sector non-bank borrower or a group of closely related borrowers without specific supervisory approval. It is recognised that newly-established or very small banks may face practical limits on their ability to diversify, necessitating higher levels of capital to reflect the resultant risk.

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9 As a guide to appropriate controls on concentrations of risk, the Basle Committee has adopted a best practices paper covering large credit exposures. This 1991 paper addresses the definitions of credit exposures, single borrowers, and related counterparties, and also discusses appropriate levels of large exposure limits, and risks arising from different forms of asset concentrations. See "*Measuring and controlling large credit exposures*" - Volume I of the Compendium.

Supervisors should monitor the bank's handling of concentrations of risk and may require that banks report to them any such exposures exceeding a specified limit (e.g., 10% of capital) or exposures to large borrowers as determined by the supervisors. In some countries, the aggregate of such large exposures is also subject to limits.

(iv) Connected lending

Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Banking supervisors must be able to prevent abuses arising from connected and related party lending. This will require ensuring that such lending is conducted only on an arm's-length basis and that the amount of credit extended is monitored. These controls are most easily implemented by requiring that the terms and conditions of such credits not be more favourable than credit extended to non-related borrowers under similar circumstances and by imposing strict limits on such lending. Supervisors should have the authority, in appropriate circumstances, to go further and establish absolute limits on categories of such loans, to deduct such lending from capital when assessing capital adequacy, or to require collateralisation of such loans. Transactions with related parties that pose special risks to the bank should be approved by the bank's board of directors, reported to the supervisors, or prohibited altogether. Supervising banks on a consolidated basis can in some circumstances reduce problems arising from connected lending.

Supervisors should also have the authority to make discretionary judgements about the existence of connections between the bank and other parties. This is especially necessary in those instances where the bank and related parties have taken measures to conceal such connections.

(v) Country and transfer risk

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate reserves against such risks.[10]

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10 These issues were addressed in a 1982 Basle Committee paper "*Management of banks' international lending*" - Volume I of the Compendium.

3. Market risk management

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

Banking supervisors must determine that banks accurately measure and adequately control market risks. Where material, it is appropriate to provide an explicit capital cushion for the price risks to which banks are exposed, particularly those arising from their trading activities. Introducing the discipline that capital requirements impose can be an important further step in strengthening the soundness and stability of financial markets. There should also be well-structured quantitative and qualitative standards for the risk management process related to market risk.[11] Banking supervisors must also ensure that bank management has set appropriate limits and implemented adequate internal controls for their foreign exchange business.[12]

4. Other risk management

Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Risk management standards[13] are a necessary element of banking supervision, and increasingly important as financial instruments and risk measurement techniques become more complex. Moreover, the effect of new technologies on financial markets both permits and requires many banks to monitor their portfolios daily and adjust risk exposures rapidly in

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11 In January 1996 the Basle Committee issued a paper amending the Capital Accord and implementing a new capital charge related to market risk. This capital charge comes into effect by the end of 1997. In calculating the capital charge, banks will have the option of using a standardised method or their own internal models. The G-10 supervisory authorities plan to use "backtesting" (i.e., ex-post comparisons between model results and actual performance) in conjunction with banks' internal risk measurement systems as a basis for applying capital charges. See "*Overview of the Amendment to the Capital Accord to incorporate market risks*", "*Amendment to the Capital Accord to incorporate market risks*", and "*Supervisory framework for the use of 'backtesting' in conjunction with the internal models approach to market risk capital requirements*" - Volume II of the Compendium.

12 See "*Supervision of banks' foreign exchange positions*" - Volume I of the Compendium.

13 The Basle Committee has recently established a sub-group to study issues related to risk management and internal controls and to provide guidance to the banking industry.

response to market and customer needs. In this environment, management, investors, and supervisors need information about a bank's exposures that is correct, informative, and provided on a timely basis. Supervisors can contribute to this process by promoting and enforcing sound policies in banks, and requiring procedures that ensure the necessary information is available.

(i) Interest rate risk

Supervisors should monitor the way in which banks control interest rate risk including effective board and senior management oversight, adequate risk management policies and procedures, risk measurement and monitoring systems, and comprehensive controls.[14] In addition, supervisors should receive sufficient and timely information from banks in order to evaluate the level of interest rate risk. This information should take appropriate account of the range of maturities and currencies in each bank's portfolio, as well as other relevant factors such as the distinction between trading and non-trading activities.

(ii) Liquidity management

The purpose of liquidity management is to ensure that the bank is able to meet fully its contractual commitments. Crucial elements of strong liquidity management include good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, and contingency planning.[15] Supervisors should expect banks to manage their assets, liabilities and off-balance sheet contracts with a view to maintaining adequate liquidity. Banks should have a diversified funding base, both in terms of sources of funds and the maturity breakdown of the liabilities. They should also maintain an adequate level of liquid assets.

(iii) Operational risk

Supervisors should ensure that senior management puts in place effective internal control and auditing procedures; also, that they have policies for managing or mitigating operational risk (e.g., through insurance or contingency planning). Supervisors must determine that banks have adequate and well-tested business resumption plans for all major systems, with remote site facilities, to protect against such events.

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14 The Basle Committee has recently issued a paper related to the management of interest rate risk that outlines a number of principles for use by supervisory authorities when considering interest rate risk management at individual banks. See "*Principles for the management of interest rate risk*" - Volume I of the Compendium.

15 The Basle Committee has issued a paper that sets out the main elements of a model analytical framework for measuring and managing liquidity. Although the paper focuses on the use of the framework by large, internationally-active banks, it provides guidance that should prove useful to all banks. See "*A framework for measuring and managing liquidity*" - Volume I of the Compendium.

5. Internal controls

Principle 14. Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Principle 15. Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

The purpose of internal controls is to ensure that the business of a bank is conducted in a prudent manner in accordance with policies and strategies established by the bank's board of directors; that transactions are only entered into with appropriate authority; that assets are safeguarded and liabilities controlled; that accounting and other records provide complete, accurate and timely information; and that management is able to identify and assess the risks of the business.

There are three primary areas of internal controls:

- organisational structures (definitions of duties and responsibilities, discretionary limits for loan approval, and decision-making procedures);
- accounting procedures (reconciliation of accounts, control lists, periodic trial balances, etc.); and
- the "four eyes" principle (segregation of various functions, cross-checking, dual control of assets, double signatures, etc.).

These controls must be supplemented by an effective audit function that independently evaluates the adequacy, operational effectiveness and efficiency of the control systems within an organisation. The auditor should be accountable to senior management or, where deemed necessary, to the board of directors to ensure independence from operational management on which it must be free to report. The external audit can provide a cross-check on the effectiveness of this process. Banking supervisors must be satisfied that effective policies and practices are followed.

Banks are subject to a wide array of banking and non-banking laws and regulations and must have in place adequate policies and procedures to ensure compliance. Otherwise, violations of established requirements can damage the reputation of the bank and expose it to penalties. In extreme cases, this damage could threaten the bank's solvency. Compliance failures also indicate that the bank is not being managed with the integrity and skill expected of a banking institution. Larger banks in particular should have independent compliance functions and banking supervisors should determine that such functions are operating effectively.

Public confidence in banks can be undermined, and bank reputations damaged, as a result of association (even if inadvertent) with drug traders and other criminals. Consequently, while banking supervisors are not generally responsible for the criminal prosecution of money laundering offences or the ongoing anti-money laundering efforts in their countries, they have a role in ensuring that banks have procedures in place, including strict "know-your-customer" policies, to avoid association or involvement with drug traders and other criminals, as well as in the general promotion of high ethical and professional standards in the financial sector.[16] Specifically, supervisors should encourage the adoption of the recommendations of the Financial Action Task Force on Money Laundering (FATF). These relate to customer identification and record-keeping, increased diligence by financial institutions in detecting and reporting suspicious transactions, and measures to deal with countries with insufficient or no anti-money laundering measures.

The occurrence of fraud in banks, or involving them, is also of concern to banking supervisors for three reasons. On a large scale it may threaten the solvency of banks and the integrity and soundness of the financial system. Second, it may be indicative of weak internal controls that will require supervisory attention. And thirdly, there are potential reputational and confidence implications which may also spread from a particular institution to the system. For these reasons, banks should have established lines of communication, both within the management chain and within an internal security or guardian function independent of management, for reporting problems. Employees should be required to report suspicious or troubling behaviour to a superior or to internal security. Moreover, banks should be required to report suspicious activities and significant incidents of fraud to the supervisors. It is not necessarily the role of supervisors to investigate fraud in banks, and the skills required to do so are specialised, but supervisors do need to ensure that appropriate authorities have been alerted. They need to be able to consider and, if necessary, act to prevent effects on other banks and to maintain an awareness of the types of fraudulent activity

16 See "*Prevention of criminal use of the banking system for the purpose of money-laundering*" - Volume I of the Compendium.

that are being undertaken or attempted in order to ensure that banks have controls capable of countering them.

6. Disclosure

In order for market forces to work effectively, thereby fostering a stable and efficient financial system, market participants need access to correct and timely information. Disclosure, therefore, is a complement to supervision. For this reason, banks should be required to disclose to the public information regarding their activities, providing a true and fair view of their financial position. This information should be timely and sufficient for market participants to assess the risk inherent in any individual banking institution.[17]

C. Methods of Ongoing Banking Supervision

Principle 16: An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

Principle 18: Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis.

Principle 19: Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking organisation on a consolidated basis.

Supervision requires the collection and analysis of information. This can be done on or off-site. An effective supervisory system will use both means. In some countries, on-site supervision is carried out by examiners and in others by qualified external auditors. In still other countries, a mixed system of on-site examinations and collaboration between the supervisors and the external auditors exists. The extent of on-site work and the method by which it is carried out depend on a variety of factors. Where on-site work is relatively

17 The Basle Committee has recently established a sub-group to study issues related to disclosure and to provide guidance to the banking industry.

infrequent, or targeted at weaker institutions, supervisors must ensure that their off-site surveillance systems are state-of-the-art.

Regardless of their mix of on-site and off-site activities or their reliance on external accountants, banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations. Review of the reports of internal and external auditors can be an integral part of both on-site and off-site supervision. The various factors considered during the licensing process should be periodically assessed as part of on-going supervision. Banks should be required to submit information on a periodic basis for review by the supervisors, and supervisors should be able to discuss regularly with banks all significant issues and areas of their business. If problems develop, banks must also feel that they can confide in and consult with the supervisor, and expect that problems will be discussed constructively and treated in a confidential manner. They must also recognise their responsibility to inform supervisors of important matters in a timely manner.

1. Off-site surveillance

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis. These should include basic financial statements as well as supporting schedules that provide greater detail on exposure to different types of risk and various other financial aspects of the bank, including provisions and off-balance sheet activities. The supervisory agency should also have the ability to obtain information on affiliated non-bank entities.

These reports can be used to check adherence to prudential requirements, such as capital adequacy or single debtor limits. Off-site monitoring can often identify potential problems, particularly in the interval between on-site inspections, thereby providing early detection and prompting corrective action before problems become more serious. Such reports can also be used to identify trends not only for particular institutions, but also for the banking system as a whole. These reports can provide the basis for discussions with bank management, either at periodic intervals or when problems appear. They should also be a key component of examination planning so that maximum benefit is achieved from the limited time spent conducting an on-site review.

2. On-site examination and/or use of external auditors[18]

Supervisors must have a means of validating supervisory information either through on-site examinations or use of external auditors. On-site work, whether done by examination staff of the banking supervisory agency or commissioned by supervisors but undertaken by external auditors, should be structured to provide independent verification that adequate corporate governance exists at individual banks and that information provided by banks is reliable.

On-site examinations provide the supervisor with a means of verifying or assessing a range of matters including:

- the accuracy of reports received from the bank
- the overall operations and condition of the bank
- the adequacy of the bank's risk management systems and internal control procedures
- the quality of the loan portfolio and adequacy of loan loss reserves
- the competence of management
- the adequacy of accounting and management information systems
- issues identified in off-site or previous on-site supervisory processes
- bank adherence to laws and regulations and the terms stipulated in the banking licence.

The supervisory agency should establish clear internal guidelines related to the frequency and scope of examinations. In addition, examination policies and procedures must be developed in order to ensure that examinations are conducted in a thorough and consistent manner with clear objectives.

Depending on its use of examination staff, a supervisory agency may use external auditors to fulfil the above functions in whole or in part. In some cases, such functions may be part of the normal audit process (e.g. assessing the quality of the loan portfolio and the level of provisions that need to be held against it). In other areas, the supervisor should have adequate powers to require work to be commissioned specifically for supervisory purposes (e.g. on the accuracy of reports filed with supervisors or the adequacy of control systems.) However, reliance should be placed on external auditors for supervisory purposes only when there is a well-developed, professionally independent auditing profession with skills to undertake the work required. In these circumstances, the supervisory agency needs to reserve

18 In some countries, external auditors hired by the supervisory agency to conduct work on its behalf are referred to as reporting accountants.

be "event generated", meaning they are filed only if a particular event occurs (e.g. investment in a new affiliate). Supervisors should be sensitive to the burden that reporting imposes. Consequently, they may determine that it is not necessary for every bank to file every report. Filing status can be based on the organisational structure of the bank, its size, and the types of activities it conducts.

3. Confirmation of the accuracy of information submitted

It is the responsibility of bank management to ensure the accuracy, completeness and timeliness of prudential, financial, and other reports submitted to the supervisors. Therefore, bank management must ensure that reports are verified and that external auditors determine that the reporting systems in place are adequate and provide accurate data. External auditors should verify the annual accounts and management report supplied to shareholders and the general public. Weaknesses in bank auditing standards in a particular country may require that banking supervisors become involved in establishing clear guidelines concerning the scope and content of the audit programme as well as the standards to be used. In extreme cases where supervisors cannot be satisfied with the work done by external auditors, they may need to reserve the right to approve the issue of accounts to the public.

In assessing the nature and adequacy of work done by auditors, and the degree of reliance that can be placed on this work, supervisors will need to consider the extent to which the audit programme has examined the quality of the loan portfolio and the method used for asset valuation, the criteria used for establishing loan loss reserves, the treatment of interest on non-performing assets, and the adequacy of internal accounting controls. Where it is competent and independent of management, internal audits may also contribute usefully to the supervisors' understanding.

4. Confidentiality of supervisory information

Although market participants should have access to correct and timely information, there are certain types of sensitive information[22] that should be held confidential by banking supervisors. In order for a relationship of mutual trust to develop, banks need to know that such sensitive information will be held confidential by the banking supervisory agency and its appropriate counterparts at other domestic and foreign supervisory agencies.

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22 The types of information considered sensitive vary from country to country; however, this typically includes information related to individual customer accounts as well as problems that the supervisor is helping the bank to resolve.

SECTION V: FORMAL POWERS OF SUPERVISORS

Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way.

A. Corrective Measures

Despite the efforts of supervisors, situations can occur where banks fail to meet supervisory requirements or where their solvency comes into question. In order to protect depositors and creditors, and prevent more widespread contagion of such problems, supervisors must be able to conduct appropriate intervention. Banking supervisors must have at their disposal adequate supervisory measures to bring about corrective action and which enable a graduated response by supervisors depending on the nature of the problems detected. In those instances where the detected problem is relatively minor, informal action such as a simple oral or written communication to bank management may be all that is warranted. In other instances, more formal action may be necessary. These remedial measures have the greatest chance of success when they are part of a comprehensive programme of corrective action developed by the bank and with an implementation timetable; however, failure to achieve agreement with bank management should not inhibit the supervisory authority from requiring the necessary corrective action.

Supervisors must have the authority not only to restrict the current activities of the bank but also withhold approval for new activities or acquisitions. They must also have the authority to restrict or suspend dividend or other payments to shareholders, as well as to restrict asset transfers and a bank's purchase of its own shares. The supervisor should have effective means to address management problems, including the power to have controlling owners, directors, and managers replaced or their powers restricted, and, where appropriate, barring individuals from the business of banking. In extreme cases, the supervisors should have the ability to impose conservatorship over a bank that is failing to meet prudential or other requirements. It is important that all remedial actions be addressed directly to the bank's board of directors since they have overall responsibility for the institution.

Once action has been taken or remedial measures have been imposed, supervisors must be vigilant in their oversight of the problems giving rise to it by periodically checking to determine that the bank is complying with the measures. There should be a progressive escalation of action or remedial measures if the problems become worse or if bank management ignores more informal requests from supervisors to take corrective action.

B. Liquidation Procedures

In the most extreme cases, and despite ongoing attempts by the supervisors to ensure that a problem situation is resolved, a banking institution may no longer be financially viable. In such cases, the supervisor can be involved in resolutions that require a take-over by or merger with a healthier institution. When all other measures fail, the supervisor must have the ability to close or assist in the closing of an unhealthy bank in order to protect the overall stability of the banking system.

SECTION VI: CROSS-BORDER BANKING

A. Obligations of Home Country Supervisors

Principle 23: Banking supervisors must practise global consolidated supervision, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by banking organisations worldwide, primarily at their foreign branches and subsidiaries.

Principle 24: A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

Banking supervisors must practice global consolidated supervision, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by banks worldwide including at their foreign branches, subsidiaries and joint ventures. A major responsibility of the parent bank supervisor is to determine that the parent bank is effectively controlling its overseas establishments, monitoring compliance with internal controls, receiving an adequate and regular flow of information, and periodically verifying the information received. In many instances, a bank's foreign offices may be conducting business fundamentally different from the bank's domestic operations. Consequently, supervisors must determine that the bank has the expertise needed to conduct these activities in a safe and sound manner.

A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, including host country supervisory authorities. This contact should commence at the authorisation stage when the host supervisor should seek the approval from the home supervisor before issuing a licence. In many cases, bilateral arrangements exist between supervisors. These arrangements can prove helpful in defining the scope of information to be shared and the conditions under which such sharing would normally be expected. Unless satisfactory arrangements for obtaining information can be agreed, banking supervisors should prohibit their banks from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.

The parent supervisor must also determine the nature and extent of supervision conducted by the host country of the local operations of the home country's banks. Where host country supervision is inadequate, the parent supervisor may need to take special additional measures to compensate, such as through on-site examinations, or by requiring additional information from the bank's head office or its external auditors. If these options can not be developed to give sufficient comfort, bearing in mind the risks involved, then the home supervisor may have no option but to request the closure of the relevant overseas establishment.

B. Obligations of Host Country Supervisors

Principle 25: Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Foreign banks often provide depth and increase competition in local banking markets. Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision. Consequently, foreign bank operations should be subject to similar prudential, inspection and reporting requirements as domestic banks (recognising, of course, obvious differences such as branches not being separately capitalised).

As the host country supervisory agency supervises only a limited part of the overall operations of the foreign bank, the supervisory agency should determine that the home country supervisor practices consolidated supervision of both the domestic and overseas operations of the bank. In order for home country supervisors to practice effectively consolidated supervision, the host country supervisor must share information about the local operations of foreign banks with them provided there is reciprocity and protection of the confidentiality of the information. In addition, home country supervisors should be given on-site access to local offices and subsidiaries for appropriate supervisory purposes. Where host country laws pose obstacles to sharing information or cooperating with home country supervisors, host authorities should work to have their laws changed in order to permit effective consolidated supervision by home countries.

The Principles set out in this Section VI are consistent with the so-called Basle Concordat and its successors.[23] The Concordat establishes understandings relating to contact

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23 See "*Principles for the supervision of banks' foreign establishments*", "*Minimum standards for the supervision of international banking groups and their cross-border establishments*", and "*The supervision of cross-border banking*", all contained in Volume III of the Compendium.

and collaboration between home and host country authorities in the supervision of banks' cross-border establishments. The most recent of these documents, developed by the Basle Committee in collaboration with the Offshore Group of Banking Supervisors and subsequently endorsed by 138 countries attending the International Conference of Banking Supervisors last June, contains twenty-nine recommendations aimed at removing obstacles to the implementation of effective consolidated supervision.

Special Issues Related to Government-owned Banks

Many countries have some commercial banks that are owned, wholly or substantially, by the national government or by other public bodies.[24] In other countries, government-owned commercial banks comprise the majority of the banking system, usually for historic reasons. In principle, all banks should be subject to the same operational and supervisory standards regardless of their ownership; however, the unique nature of government-owned commercial banks must be recognised.

Government-owned commercial banks are backed by the full resources of the government. This provides additional support and strength for these banks. Although this government support can be advantageous, it should also be noted that the correction of problems at these banks is sometimes deferred and the government is not always in a position to recapitalise the bank when required. At the same time, this support may lead to the taking of excessive risks by bank management. In addition, market discipline may be less effective when market participants know that a particular bank has the full backing of the government and consequently has access to more extensive (and possibly cheaper) funding than would be the case for a comparable privately-owned bank.

Consequently, it is important that supervisors seek to ensure that government-owned commercial banks operate to the same high level of professional skill and disciplines as required of privately-owned commercial banks, both to protect the taxpayer and to preserve a strong credit and control culture in the banking system as a whole. This can be more difficult for supervisors in that corporate governance at such banks is often weaker and the supervisors may have less influence over the senior management of such banks and less ability to remove them, when necessary. Nevertheless, supervisors should apply their supervisory methods in the same manner to government-owned commercial banks as they do to all other commercial banks.

24 These commercial banks are different from "policy" banks that typically specialise in certain types of lending or target certain sectors of the economy.

APPENDIX II

Deposit Protection

Despite the efforts of supervisors, bank failures can occur. At such times, the possible loss of all or part of their funds increases the risk that depositors will lose confidence in other banks. Consequently, many countries have established deposit insurance plans to protect small depositors. These plans are normally organised by the government or central bank, or by the relevant bankers' association. Deposit insurance provides a safety net for many bank creditors thereby increasing public confidence in banks and making the financial system more stable. A safety net may also limit the effect that problems at one bank might have on other, healthier, banks in the same market, thereby reducing the possibility of contagion or a chain reaction within the banking system as a whole. A key benefit of deposit insurance is that, in conjunction with logical exit procedures, it gives the banking supervisors greater freedom to let problem banks fail.

Deposit insurance can however increase the risk of imprudent behaviour by individual banks. Small depositors will be less inclined to withdraw funds even if the bank pursues high-risk strategies, thus weakening an important check on imprudent management. Government officials and supervisors need to recognise this effect of a safety net and take steps to prevent excessive risk-taking by banks. One method of limiting risk-taking is to utilise a deposit insurance system consisting of "co-insurance." Under such a system, the deposit insurance covers a percentage (e.g. 90%) of individual deposits and/or provides cover only up to a certain absolute amount so that depositors still have some funds at risk. Other methods include charging risk-based premiums or withholding deposit insurance from large, institutional depositors.

The actual form of such a programme should be tailored to the circumstances in, as well as historical and cultural features of, each country.[25]

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25 Some form of banking deposit insurance exists in all of the member countries of the Basle Committee. The experiences of these countries should prove useful in designing a deposit insurance programme. See "*Deposit protection schemes in the G-10 countries*" - See Volume III of the Compendium.

IOSCO PRINCIPLES AND RECOMMENDATIONS FOR THE REGULATION AND SUPERVISION OF SECURITIES MARKETS

Prepared for the G-10 Working Group on
Financial Stability in Emerging Market Economies

Montreal, April 7, 1997

I. IOSCO: Structure and Objectives

IOSCO is the international forum for securities regulators, constituted by 134 member agencies from 81 countries. IOSCO's membership encompasses the whole range of agencies, associations and organizations involved in the regulation and development of securities markets world-wide. IOSCO's work program therefore has a global reach and global impact, both in terms of geography and range of affected markets.

As stated in the Organization's By-Laws, IOSCO members have resolved to:

- cooperate together to promote high standards of regulation in order to maintain just, efficient and sound markets;
- exchange information on their respective experiences in order to promote the development of domestic markets;
- unite their efforts to establish standards and an effective surveillance of international securities transactions;
- provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards and by effective enforcement against offences.

Any agency requesting admission to the membership of IOSCO must commit to these basic principles as well as to the Resolutions adopted by IOSCO's Presidents Committee before the application is considered.

II. The Work of IOSCO: Consensus and Cooperation

IOSCO's work program is designed to develop high quality standards and promote market integrity through a process of member consensus and cooperation. Management of the Organization is the responsibility of the Executive Committee, an elected body consisting of 19 member agencies. The substantive work of the Organization is conducted by the Technical Committee and the Emerging Markets Committee ("EMC"), with important policy and organizational decisions adopted by the entire membership convened as the Presidents Committee. The Technical Committee is composed of 16 members representing the larger, more developed and internationalized markets, and the EMC is composed of 56 members representing the emerging markets. In addition, IOSCO has constituted four Regional Standing Committees: the Africa/ Middle-East Regional Committee, the Asia-Pacific Regional Committee, the European Regional Committee and the Interamerican Regional Committee. These Committees meet periodically to discuss matters specific to their respective regions.

Each member of an IOSCO Committee is represented by its Chairman or Chief Executive; the IOSCO consultative and decision making process therefore involves the top representatives of the world's securities regulators, from both the emerging markets and the more developed markets. IOSCO is supported by a small Secretariat based in Montreal, Canada, and the work of the Organization is conducted through the Committees and Working Groups (as described below) by senior and expert representatives of the member agencies.

The structure of IOSCO, combining global reach, participation by members at the highest level, and consensus-building, ensures that IOSCO's recommendations, guidelines and work product reflect global concerns, including those particular to emerging markets, and are accepted by virtually all of the world's securities regulators. This high level of consensus and support from the world-wide community of regulators is particularly important as it can provide the support that member agencies need to promote domestic legislative change. This role of IOSCO as a forum for promoting market integrity and investor confidence in individual domestic markets promotes financial stability world-wide.

III. Working to Meet the Needs of Emerging Securities Markets

The concerns and interests of regulators in emerging economies, and the need to foster sound regulatory systems, have always had a high priority in IOSCO's work agenda. This is reflected in IOSCO's broad membership structure, and the participation of both emerging and developed economies in all of IOSCO's work.

The structure and objectives of the EMC reflect IOSCO's commitment to the development of sound regulatory principles in emerging securities markets. The objectives of the EMC are:

- the development and improvement of the efficiency of emerging securities markets through the establishment of sound regulatory principles and minimum standards;
- the preparation of training programs for the personnel of members;
- the exchange of information; and
- the transfer of technology and expertise.

The EMC Steering Committee oversees the activities of the five EMC Working Groups. The EMC Steering Committee is made up of the EMC members that sit on the Executive Committee and the five Working Group Chairmen, and chaired by the Chairman of the EMC. Members meet and communicate on a regular basis during the year in order to ensure that the five Working Groups follow their mandated terms of reference and specific work programs as closely and as efficiently as possible.

The Technical Committee and the EMC have adopted parallel working group structures. The EMC Working Groups pursue their mandates in two parallel directions: (1) issues of specific interest to EMC members; and (2) issues being examined by the parallel Technical Committee

Working Group. The Technical Committee and the EMC have also agreed to exchange observers on Working Groups in order to enhance practical cooperation. The EMC Working Group chairmen therefore receive and provide input from and to the Technical Committee Working Groups. This high degree of coordination and cooperation between the two Committees enables the EMC to better focus its resources on some of the practical difficulties specifically encountered by its members.

In addition to supporting the particular focus of the EMC, IOSCO continues to seek ways to incorporate the concerns and interests of regulators in emerging markets into the Organization as a whole. For example, IOSCO recently increased the representation of emerging markets regulators on the IOSCO Executive Committee and reinforced the importance of regional groupings within the formal structure of the Organization. This new structure has also enhanced the ability of IOSCO to address issues and make recommendations that are valid for both emerging and developed markets.

In addition, IOSCO is committed to long-term training for securities regulators from emerging markets. IOSCO is currently planning a new educational program, directed by the Secretary General and designed to facilitate the transfer of regulatory expertise within the Organization. The focus of the initial program, expected to be held in September 1997, will be the regulation of financial intermediaries (in particular brokers and financial advisers) in emerging markets. By conducting a training program on the practical aspects of the licensing, regulation and inspection of broker-dealers and other market participants, IOSCO can foster more effective supervision of market intermediaries, and thereby contribute to market confidence and integrity.

For more than 10 years IOSCO has conducted an On-the-Job Training Program, in the course of which approximately sixty staff members of regulatory agencies from emerging markets have received training at member agencies in more developed markets. The On-the-Job Training Program provides a useful complement to the extensive inter-agency training programs that have been in place at IOSCO member agencies for many years and have contributed to the development of sound regulatory structures and practices for emerging markets.

IV. WORKING GROUPS AND COORDINATION OF REGULATORY INITIATIVES

The structure of IOSCO results in a work product that is relevant to both developed and emerging markets. As described above, the EMC and the Technical Committee have adopted analogous working group structures with parallel overall mandates, and while the EMC Working Groups focus on issues specific to emerging markets, the Groups maintain a close liaison with their parallel groups in the other Committee. This structure fosters mutual awareness of issues and approaches, and allows IOSCO to speak with a unified voice. The five Working Groups of the Technical and Emerging Markets Committees are as follows:

A. Working Group No. 1 on Cross-Border Offerings and Listings:

Promoting the achievement of high, comparable, accounting, auditing and disclosure standards to facilitate cross-border securities offerings;

B. Working Group No. 2 on Regulation of Secondary Markets:

Promoting measures to enhance the transparency, integrity and robustness of financial markets and market processes;

C. Working Group No. 3 on Regulation of Financial Intermediaries:

Promoting the development of effective supervisory arrangements for securities firms and, in particular, for internationally active and diversified groups;

D. Working Group No. 4 on Enforcement and the Exchange of Information:

Promoting improved cooperation and communication among regulatory authorities, and contributing to the battle against international financial fraud;

E. Working Group No. 5 on Investment Management:

Promoting standards to facilitate the cross-border regulation of internationally marketed collective investment schemes ("CIS") and their fund managers.

V. SUBSTANTIALLY ALL OF IOSCO'S WORK PROGRAM AND REGULATORY INITIATIVES ARE INTENDED TO FOSTER SOUND REGULATORY PRINCIPLES IN EMERGING AND DEVELOPED MARKETS

IOSCO's work product takes many forms, including: member resolutions; recommendations for action; model guidelines; reports; and the promulgation of principles. Indeed, IOSCO has produced more than 40 reports and other documents which, taken together, embody comprehensive principles and guidelines for the regulation and supervision of securities and futures markets world-wide. Through their dissemination among the IOSCO membership, these principles and guidelines contribute in a very real and tangible way to the development of transparent markets, investor protection and financial stability. While, as described below and in the attached Appendix, specific work projects have focused on the particular interests of the emerging markets, all of IOSCO's work promotes high regulatory standards and strong markets throughout the world.

For the purposes of this memorandum, these initiatives have been organized under the seven key elements that are common to any sound securities regulatory regime. The common theme underlying each of these elements is the promotion and development of market integrity and investor confidence.

A. Measures Designed to Enhance the Authority of Securities Regulators to Act in a Timely and Objective Manner in Enforcing Securities Laws and Investigating Potential Violations

The dramatic growth of international financial operations has had a major impact on the work of securities regulators. In an age of borderless markets, regulators must work together internationally in order to be effective domestically. IOSCO has long stood for the importance of cooperation and assistance in enhancing the ability of regulators to enforce securities and futures laws and investigate potential violations. Through the efforts of IOSCO, securities and futures regulators have established mechanisms to share information necessary to investigate cross-border frauds and permit the initiation of legal action against wrongdoers.

In 1994, IOSCO members reaffirmed their commitment to mutual assistance and cooperation by adopting a **Resolution on Commitment to Basic IOSCO Principles of High Regulatory Standards and Mutual Cooperation and Assistance**. Among other things, the resolution calls on each IOSCO member to conduct an evaluation of its own ability to collect and share information, including information about the beneficial ownership of bank and brokerage accounts. This self-evaluation process is currently underway. In addition, a task force consisting of the Chairmen of the Executive, Technical and Emerging Markets Committees has been formed to develop recommendations for building on the self-evaluations to encourage and improve international cooperation. Recommendations are expected to include strategies for enhancing information disclosure by under-regulated and uncooperative jurisdictions. IOSCO addressed the challenges presented by such jurisdictions in its *Report on Under-Regulated and Uncooperative Jurisdictions* (October 1994), in which it made a series of **recommendations for collective action**.

Given the ease with which funds can be transferred from one jurisdiction to another, and thereby out of the reach of defrauded investors, there is also a need for regulators to cooperate with one another in order to track and facilitate the recovery of funds across international borders. In this regard, IOSCO has issued **recommendations** relating to:

- adopting measures and mechanisms to deprive perpetrators of financial fraud of the proceeds of their activities;
- highlighting potential pathways for improvements in jurisdictions where there are few means to address the issue; and
- facilitating the return of the assets and interests of defrauded investors to their legitimate owners.

These recommendations are contained in an IOSCO report focusing on the means used by 27 different jurisdictions to protect the interests and assets of defrauded investors (*Measures Available on a Cross-Border Basis to Protect Interests and Assets of Defrauded Investors* (July 1996)).

In 1991, IOSCO promulgated ten **Principles for use by securities and futures regulatory authorities in developing MOUs with their foreign counterparts** (*Principles of Memoranda of Understanding*, September 1991). These Principles have been incorporated into many of the more than 300 MOUs now in existence world-wide. The development of an extensive network of MOUs has resulted in greatly improved cooperation among regulators, contributing to the maintenance of safe and secure markets.

B. Establishing Clear Regulatory Responsibility for Licensing and Regulation of Securities Market Participants and Transactions, Including Reporting, Record Keeping, Inspection and Disciplinary Procedures

Clear, well-defined procedures for licensing and regulation of securities market participants and transactions are crucial to sound regulatory systems in both developed and emerging markets. In light of this principle the President's Committee adopted a **Resolution on International Conduct of Business Principles** setting out the basic standards of business conduct for financial firms. In adopting this resolution, IOSCO members underscored the importance of implementing and promoting these principles in their jurisdictions.

IOSCO has recognized that it is critical to the public confidence in financial markets that client assets be properly handled and accounted for. The threat to client assets is perhaps most acute when the firm is unable to compensate its clients for losses because it is facing insolvency. Therefore, IOSCO has published **twenty recommendations on measures and mechanisms that jurisdictions should establish as best practice to provide a high level of protection for assets and interests of clients held by financial intermediaries.** A self-assessment has been initiated to determine the level of compliance of IOSCO members with these recommendations. (*Report on Client Asset Protection*, August 1996).

Procedures for the orderly disposition of a market default are a key component of any sound regulatory regime, and are essential to investor confidence. This is specially true in the dynamic area of futures and options transactions. IOSCO has affirmed the importance of transparency of market default procedures for providing certainty and predictability to market participants, facilitating orderly handling in the event of a default, and enabling market participants to make informed assessments. The issue has been addressed in three specific measures:

- the **publication of a list of information items that should be available to market participants** as to market default procedures regarding futures and options trading;

- **a recommendation on Communications upon Implementation of Default Procedures**;

- **recommendations for Best Practices on the Treatment of Positions, Funds and Assets in the Event of the Default of a Member Firm**. These recommendations are designed to permit prompt isolation of problems in order to minimize systemic risk.

All of the above can be found in the March 1996 report entitled *Default Procedures*.

IOSCO work in progress includes a report on the regulatory framework for short selling and securities lending by market intermediaries, which should help EMC members better address key regulatory issues in these areas.

Emerging markets are also addressing the challenges presented by the rapid growth in derivatives activities. In 1994 IOSCO published a set of **principles and guidelines for the development of derivatives markets in emerging markets**. These principles and guidelines deal with the conditions for the development and regulation of derivative markets, and the characteristics of an adequate financial infrastructure and market structure (*Report of the Development Committee Task Force on Derivatives* (September 1994)).

Following up on the 1994 Report, IOSCO published a set of **guidelines and recommendations on the appropriate regulatory approach for jurisdictions that are developing or plan to develop derivatives markets** (*Legal and Regulatory Framework for Exchange Traded Derivatives* (1996)). This Report makes use of reports from six emerging market agencies (Brazil, Chinese Taipei, Korea, Malaysia, South Africa and Thailand) that describe their experiences and plans in the area of derivative markets regulation. These analyses provide a useful reference for jurisdictions considering the development of derivatives markets.

It is worth mentioning in this context that the CVM of Brazil, a member of the EMC, has for the past two years offered Training Sessions on Practical Aspects of the Development and Operation of Derivatives Markets, directed to regulators from emerging economies.

IOSCO also has discussions in progress with the Bank for International Settlements ("BIS") Committee on Payment and Settlement Systems ("CPSS") regarding regulatory issues related to securities custody and lending.

C. Auditing, Accounting and Disclosure Standards for Securities Issuers, and Corporate Governance Standards to Ensure Protection and Enforcement of Shareholders Rights

One of IOSCO's most important initiatives is its coordination with the International Accounting Standards Committee ("IASC") as the IASC works to develop a core set of high-quality international accounting standards ("IAS"). In July 1995, IOSCO and the IASC agreed to a workplan that, upon successful completion, currently scheduled for March 1998, could result in IOSCO endorsement of IAS for use in cross-border capital raising and listing in global markets. IOSCO has been engaged in an intensive review and consultative process with the IASC, including attendance as an observer at IASC Board meetings, designed to promote progress on this undertaking.

IOSCO has begun an analysis of the work of the International Federation of Accountants ("IFAC") towards the development of acceptable International Standards for Audits ("ISA"). A comparison of certain of the ISAs to several national auditing standards has been initiated. The results of this work will be used to guide future substantive discussions with IFAC during 1997.

Additional IOSCO measures to improve disclosure standards include:

- Development of **international standards for non-financial statements disclosures** for use by foreign issuers in cross-border offerings and listings;

- publication in 1994 of **recommendations for minimum disclosure standards for public securities offerings** and a *Model Prospectus for Emerging Markets;* and

- publication in 1996 of **guidelines for the reporting of material events by issuers of publicly traded securities in emerging markets** (*Reporting of Material Events*).

IOSCO work in progress includes standards for *Interim Reporting and Presentation of Financial Statements.*

D. Strengthening Enforcement of Laws and Regulations Against Fraud and Market Manipulation by Requiring the Establishment of Audit Trails with Respect to Trading, Clearance and Settlement Activities

IOSCO has devoted a substantial measure of attention and energy to promote sound, effective and efficient market processes. For example, in 1992 IOSCO published a detailed **blueprint for establishing or developing an efficient and risk-minimizing clearing and settlement system in emerging market economies** (*Clearing and Settlement in Emerging Markets: A Blueprint*). The blueprint uses the nine recommendations of the Group of Thirty (G-30) on clearing and settlement to frame the characteristics of an efficient clearing and settlement system, and goes on to discuss both the non-technical policy issues that must be addressed and the technical design questions. As a practical follow-up to this work, the Malaysian Securities Commission, a member of the EMC of IOSCO, will be holding a training session and an international seminar on clearing and settlement in emerging economies, on March 3-5, 1997, directed to regulators of emerging markets.

Another example of IOSCO initiatives in the area of clearing and settlement is the recent development, with the BIS's CPSS, of a disclosure framework for securities settlement. This framework will assist regulators and market participants in evaluating the risks associated with cross-border securities settlement.

IOSCO work in progress in this area also includes: (i) development of a legal framework to support the operations of central securities depositories and to offer a greater degree of legal certainty for participants; and (ii) a report, *Implications of the Use of Internet and Other Electronic Networks on the Regulation of Secondary Markets.*

E. Supervision of Market Intermediaries, including the Establishment of Financial Responsibility Requirements

Effective supervision of market intermediaries is essential to the maintenance of just, efficient and sound markets. IOSCO continues to devote a great deal of effort and attention to this area, as demonstrated by the work product of the Technical Committee and EMC Working Parties on the Supervision of Market Intermediaries. In this regard, because IOSCO believes that close international cooperation is essential, it has continued to increase its cooperative activities with other regulatory groups as called for by the G-7 Ministers in their 1995 and 1996 Communiqués. Among other things, IOSCO and the Basle Committee have jointly established **eight major principles of supervision** which set out the overarching objectives of the supervision of market intermediaries. These principles are:

- cooperation and information flows among supervisory authorities should be as free as possible from impediments both nationally and internationally;
- all banks and securities firms should be subject to effective supervision, including the supervision of capital;
- geographically and/or functionally diversified financial groups require special supervisory arrangements;
- all banks and securities firms should have adequate capital;
- proper risk management by the firm is a prerequisite for financial stability;
- the transparency and integrity of markets and supervision rely on adequate reporting and disclosure of operations;
- the resilience of markets to the failure of individual firms must be maintained;
- the supervisory process needs to be constantly maintained and improved.

(*Joint Statement of IOSCO and the Basle Committee on Banking Supervision* (May 1996))

Other important initiatives taken by IOSCO to foster more effective supervision of market intermediaries include a survey on capital adequacy regimes for market intermediaries among members of the EMC, which is scheduled for completion during 1997. The EMC also expects to issue a report, during 1997, on *Financial Risk Management in Emerging Derivatives Markets*, which will review policies and actions taken by EMC members with respect to supervision of derivatives markets' risk management.

One of the key factors in the effective supervision of market intermediaries is the financial responsibility of market participants. IOSCO has taken several important initiatives in this field, especially on the topic of the management and mitigation of potential risks associated with derivatives positions. For example:

- the world-wide growth of the OTC derivatives business led to the adoption by IOSCO in March 1996 of a **recommendation on the *Recognition of Bilateral Netting Agreements in the Calculation of Capital Requirements for Securities Firms***. This recommendation takes note of the increasing importance of the OTC derivatives business as a proportion of the overall business of securities firms, and encourages the use of legally enforceable bilateral netting agreements by authorized securities firms;

- the growth in derivatives trading activity in the securities sector has prompted firms to develop methods to analyse, control and report their trading risk in a consistent and reliable way. Firms have increasingly been turning to more sophisticated quantitative based risk management methodologies using modern option and portfolio theory. This trend has led to the development of value at risk modelling techniques. The IOSCO Technical Committee is currently considering the appropriateness of the use of value at risk models by securities regulators for capital adequacy purposes and continues to cooperate with the Basle Committee on model testing and analysis. The basis for this consideration is the July 1995 report on the *Implications for Securities Regulators of the Increased Use of Value-at-Risk Models by Securities Firms*. This Report recognises the role played by value at risk models in improving internal controls and risk-based capital standards for securities firms. The Report explains how the value at risk models are constructed, points out the role that models should play as part of a firm's risk management procedures, and considers the implications for securities regulators of recognising the output of value at risk models for the purpose of calculating capital requirements for market risk.

IOSCO recognizes that supervisors should continuously improve their understanding of how exchange-traded and OTC derivatives affect the overall risk profile and profitability of market intermediaries. IOSCO and the Basle Committee have set out **guidelines for the types of information that regulators and supervisors should obtain from banks and securities**

firms in order to form a judgement as to the risks associated with proprietary and client-based derivative trading activities. (*Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* (May 1995)).

IOSCO and the Basle Committee have also jointly prepared a set of **recommendations for improved disclosure of both quantitative and qualitative information about derivative trading activities**. These recommendations are contained in *Public Disclosure of the Trading Activities of Banks and Securities Firms* (November 1995), which also reviews disclosure practices adopted by a large number of banks and securities firms in their 1994 annual accounts. An update to this report, including 1995 data, was released in November 1996.

F. Establishing Open, Transparent Stock Exchanges and Other Self-Regulatory Organizations ("SROs") for Market Participants, Which are Subject to Oversight by the Securities Regulator

IOSCO is uniquely placed to foster international cooperation and information sharing between securities regulators. It is important that market authorities closely monitor exposures that are large enough to put the market at risk and share information with one another so as to manage market risk.

IOSCO has put forward some important **recommendations for cooperation between market authorities in the monitoring of and exchange of information on large exposures on futures and options markets.** IOSCO **recommends** that market authorities (regulatory bodies, SROs or the markets themselves) consider establishing trigger levels for open positions so that, when the trigger levels are reached, the beneficial owner of an open position can be identified. Given the increasing internationalization of trading activities, IOSCO also **recommends** that market authorities open and maintain channels of communication with one another in order to share information regarding large exposures. The recommendations propose the use of Information Sharing Arrangements between market authorities, and set forth the essential elements of such arrangements. (*Cooperation Between Market Authorities* (March 1996)).

IOSCO work in progress includes the development of **guidelines for surveillance techniques and practices to detect and prosecute price manipulation.**

G. Establishing Standards of Regulation for Collective Investment Schemes

Collective Investment Schemes (CIS) are a rapidly growing sector of the securities business, and IOSCO has devoted a great deal of attention to CIS-related issues. CIS are of particular interest to emerging markets: they offer a flexible, simple and convenient means for investors, including small savers, to participate in domestic and international securities markets. The development of CIS can therefore increase both foreign and domestic investment in an emerging market. IOSCO has devoted significant time and attention to the development of sound regulatory principles for CIS, thereby contributing to the growth and stability of emerging markets.

IOSCO has recommended **core principles for the development and supervision of CIS**, focusing specifically on the needs of emerging markets regulators. These recommendations, contained in the recent IOSCO report, *Collective Investment Schemes*, provide guidance for the regulatory activities of EMC members. In order that emerging markets can apply solutions that best fit their own particular circumstances, the report also includes a comparative analysis of the CIS regulatory regimes in place in four EMC member jurisdictions.

International regulatory cooperation can be of critical importance to maintaining market integrity in emergencies involving the cross-border activity of CIS. These emergencies can take the forms of the insolvency or threatened insolvency of the CIS manager, trustee, custodian or affiliated company, or of a misappropriation of funds. The increased internationalization of the markets in which CIS and their principals operate can give these emergencies cross-border implications. Therefore, IOSCO has developed a set of **recommended policies for cooperation between regulators during an emergency**, and a set of **general principles for regulators to consider in the context of the suspension of dealing and marketing** (*Regulatory Cooperation in Emergencies* (June 1996)).

The increasing popularity of the CIS as an investment vehicle has also increased the need for disclosure of risk. Market integrity and investor protection hinge on the issue of accurate disclosure, and IOSCO has **recommended** a variety of ways of improving the presentation of risk factors in CIS offering documents and advertising, and proposed **policies** for ensuring that financial intermediaries adequately explain the risks of CIS investment to potential investors (*Disclosure of Risk - A Discussion Paper* (September 1996)).

Another category of risks to be addressed in the context of CIS are those risks regarding the custody of cash deposits and non-cash assets. The failure of a financial institution with responsibility for custody will have consequences for CIS regulators, supervising CIS and fund management entities alike. The increase in cross-border activity led IOSCO to issue **guidelines** on the subjects of contractual arrangements between a custodian and the operator of a CIS, including the selection and authorization of custodians, co-mingling of assets and omnibus accounts, and monitoring of custody arrangements. (*Guidance on Custody Arrangements for Collective Investment Schemes - A Discussion Paper* (September 1996)).

VI. CONCLUSION

The dramatic increase in securities transactions and the increasingly globalized marketplace has set new challenges for securities regulators world-wide. The members of IOSCO recognize that market integrity, investor protection and financial stability can only be achieved through a high level of cooperation and communication. IOSCO provides the forum for that cooperation and communication, allowing members to share their expertise, make concrete their commitment to the goals of market integrity and investor protection, provide practical assistance to other members, and supply critical leverage to regulators seeking to influence domestic legislation and regulation. IOSCO's commitment to these goals, accompanied by its global reach, participation by members at the highest level, and consensus-building have enabled IOSCO to make important contributions to the development of sound securities regulatory principles in both emerging and developed markets.

ACTIVITIES OF THE EMC WORKING GROUPS

EMC activities, particularly those of its Working Groups, have strengthened the cooperation between its members and have contributed to the development of an integrated approach for the development of standards for improving the transparency of emerging securities and futures markets.

A. Working Group No. 1: Disclosure and Accounting

In coordination with the Working Group No. 1 of the Technical Committee, the Working Group is addressing the development of standards to facilitate multi-jurisdictional securities offerings, which take into account the market experiences and particularities of EMC members. It is also working towards developing a set of recommendations of Interim Reporting in relation to "*Presentation of Financial Statements*". In its last meeting, the EMC approved the report entitled "*Reporting Material Events*".

B. Working Group No. 2: Regulation of Secondary Markets

This Working Group has a specific mandate to develop a legal and regulatory framework for cash and derivative markets in emerging jurisdictions.

A Report entitled "*The Legal and Regulatory Framework for Exchange Traded Derivatives*" was made public at IOSCO's most recent Annual Conference and serves as a very useful reference document for jurisdictions considering the development of derivatives markets. The report encompasses the following issues and regulatory objectives:

- Market Integrity and Efficiency: Product Design, Order Execution; Surveillance and Operational Capacity;
- Financial Safety and Integrity: Capital Standards; Clearing Facility; Margins; Protection of Customers Funds; Default, Insolvency of Bankruptcy Provisions, Market Disruptions;
- Customer Protection and Fairness: Automation/Registration/Licensing; Order Execution; Record Keeping; Sales Representation and Disclosure; Product Design; Dispute Resolution Programs;
- Compliance and Enforcement.

The EMC has also authorized the Working Group to develop a legal framework to support the operations of central securities depositories and to offer a greater degree of legal certainty to participants. Two other mandates relate to financial risk management in emerging derivatives markets and transparency relating to block trading.

C. Working Group No. 3: Regulation of Market Intermediaries

This Working Group has a specific mandate to identify the objectives and criteria of capital adequacy standards enforced in the jurisdictions of EMC members along with the type of risks involved. It is also developing a comparative analysis of the regulatory approaches used by EMC members, including a description of regulatory issues in the area of the regulation of market intermediaries. The Working Group is planning to design a capital adequacy regime for jurisdictions represented within the EMC, which would use a variable approach depending on the level of development of capital markets and, in particular, the degree of sophistication of the financial instruments used.

The EMC gave the Working Group a new mandate pertaining to short selling and securities lending by market intermediaries and has also asked the Working Group to assist its Technical Committee Working Party counterpart in the preparation of a self-evaluation questionnaire to determine the level of implementation by IOSCO members of the recommendations contained in the Technical Committee report on *Client Asset Protection.*

D. Working Group No. 4: Enforcement and the Exchange of Information

Working Group No. 4 has a specific mandate to create conditions for improving and sharing enforcement expertise among EMC members. It is encouraging the efforts of EMC members to combat international securities fraud, and at the same time is working on the identification of principles of securities regulation in areas such as the organization of regulatory and supervisory systems, and the investigation and enforcement powers of supervisory authorities. The Working Group drafted the two Resolutions adopted by the EMC in September 1996, namely "*Proposal of Recommendation on Standard Catalogue of Illicit Activities to be Recognized and Penalized on the Securities Markets*"; and "*Proposal of Recommendation on the Enforcement Powers of a Securities and Futures Markets Supervisory Agency*".

It has also started work on its mandate relating to the development of guidelines for surveillance techniques and practices for detecting and prosecuting, for law enforcement purposes, price manipulation on the securities markets.

At its most recent meeting, the EMC approved a report entitled "*Discussion Paper on Class Action or Other Provisions Designed to Protect the Interest of Defrauded Investors in Civil Proceedings*".

E. Working Group No. 5: Investment Management

EMC Working Group No. 5 has a specific mandate to determine regulatory objectives for the promotion and supervision of investment management services and to structure an appropriate regulatory framework for EMC members that would take into consideration high, medium or low intensity regulation.

The Working Group also has to evaluate the role of the regulatory authorities and to prepare a comparative analysis of the different systems used for the promotion or development of investment management services in developed as well as emerging markets.

The EMC recently approved a Report entitled "Collective Investment Schemes" which concentrates on the needs of emerging markets regulators pertaining to the regulations of CIS. The Report also embodies basic principles for the development and supervision of CIS and also includes a comparative analysis of the CIS regulatory regimes in 4 EMC countries.

The Working Group plans also to address issues relating to cross-border marketing of CIS.

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International Accounting Standard IAS 30 (reformatted 1994)

Disclosures in the Financial Statements of Banks and Similar Financial Institutions

The standards, which have been set in bold italic type, should be read in the context of the background material and implementation guidance in this Standard, and in the context of the Preface to International Accounting Standards. International Accounting Standards are not intended to apply to immaterial items (see paragraph 12 of the Preface).

Scope

1. ***This Standard should be applied in the financial statements of banks and similar financial institutions (subsequently referred to as banks).***

2. For the purposes of this Standard, the term "bank" includes all financial institutions, one of whose principal activities is to take deposits and borrow with the objective of lending and investing and which are within the scope of banking or similar legislation. The Standard is relevant to such enterprises whether or not they have the word "bank" in their name.

3. Banks represent a significant and influential sector of business worldwide. Most individuals and organisations make use of banks, either as depositors or borrowers. Banks play a major role in maintaining confidence in the monetary system through their close relationship with regulatory authorities and governments and the regulations imposed on them by those governments. Hence there is considerable and widespread interest in the well-being of banks, and in particular their solvency and liquidity and the relative degree of risk that attaches to the different types of their business. The operations, and thus the accounting and reporting requirements, of banks are different from those of other commercial enterprises. This Standard recognises their special needs. It also encourages the presentation of a commentary on the financial statements which deals with such matters as the management and control of liquidity and risk.

IAS 30 (reformatted 1994)

4. This Standard supplements other International Accounting Standards which also apply to banks unless they are specifically exempted in a Standard.

5. This Standard applies to the separate financial statements and the consolidated financial statements of a bank. Where a group undertakes banking operations, this Standard is applicable in respect of those operations on a consolidated basis.

Background

6. The users of the financial statements of a bank need relevant, reliable and comparable information which assists them in evaluating the financial position and performance of the bank and which is useful to them in making economic decisions. They also need information which gives them a better understanding of the special characteristics of the operations of a bank. Users need such information even though a bank is subject to supervision and provides the regulatory authorities with information that is not always available to the public. Therefore disclosures in the financial statements of a bank need to be sufficiently comprehensive to meet the needs of users, within the constraint of what it is reasonable to require of management.

7. The users of the financial statements of a bank are interested in its liquidity and solvency and the risks related to the assets and liabilities recognised on its balance sheet and to its off balance sheet items. Liquidity refers to the availability of sufficient funds to meet deposit withdrawals and other financial commitments as they fall due. Solvency refers to the excess of assets over liabilities and, hence, to the adequacy of the bank's capital. A bank is exposed to liquidity risk and to risks arising from currency fluctuations, interest rate movements, changes in market prices and from counterparty failure. These risks may be reflected in the financial statements, but users obtain a better understanding if management provides a commentary on the financial statements which describes the way it manages and controls the risks associated with the operations of the bank.

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Accounting Policies

8. Banks use differing methods for the recognition and measurement of items in their financial statements. While harmonisation of these methods is desirable, it is beyond the scope of this Standard. In order to comply with International Accounting Standard IAS 1, Disclosure of Accounting Policies, and thereby enable users to understand the basis on which the financial statements of a bank are prepared, accounting policies dealing with the following items may need to be disclosed:

   (a) the recognition of the principal types of income (see paragraphs 10 and 11);

   (b) the valuation of investment and dealing securities (see paragraphs 24 and 25);

   (c) the distinction between those transactions and other events that result in the recognition of assets and liabilities on the balance sheet and those transactions and other events that only give rise to contingencies and commitments (see paragraphs 26 to 29);

   (d) the basis for the determination of losses on loans and advances and for writing off uncollectable loans and advances (see paragraphs 43 to 49); and

   (e) the basis for the determination of charges for general banking risks and the accounting treatment of such charges (see paragraphs 50 to 52).

   Some of these topics are the subject of existing International Accounting Standards while others may be dealt with at a later date.

Income Statement

9. *A bank should present an income statement which groups income and expenses by nature and discloses the amounts of the principal types of income and expenses.*

10. In addition to the requirements of other International Accounting Standards, the disclosures in the income statement or the notes to the financial statements should include, but are not limited to, the following items of income and expenses:

Interest and similar income;

Interest expense and similar charges;

Dividend income;

Fee and commission income;

Fee and commission expense;

Gains less losses arising from dealing securities;

Gains less losses arising from investment securities;

Gains less losses arising from dealing in foreign currencies;

Other operating income;

Losses on loans and advances;

General administrative expenses; and

Other operating expenses.

11. The principal types of income arising from the operations of a bank include interest, fees for services, commissions and dealing results. Each type of income is separately disclosed in order that users can assess the performance of a bank. Such disclosures are in addition to those of the source of income required by International Accounting Standard IAS 14, Reporting Financial Information by Segment.

12. The principal types of expenses arising from the operations of a bank include interest, commissions, losses on loans and advances, charges relating to the reduction in the carrying amount of investments and general administrative expenses. Each type of expense is separately disclosed in order that users can assess the performance of a bank.

13. Income and expense items should not be offset except for those relating to hedges and to assets and liabilities which have been offset in accordance with paragraph 23.

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14. Offsetting in cases other than those relating to hedges and to assets and liabilities which have been offset as described in paragraph 23 prevents users from assessing the performance of the separate activities of a bank and the return that it obtains on particular classes of assets.

15. Gains and losses arising from each of the following are normally reported on a net basis:

    (a) disposals and changes in the carrying amount of dealing securities;

    (b) disposals of investment securities; and

    (c) dealings in foreign currencies.

16. Interest income and interest expense are disclosed separately in order to give a better understanding of the composition of, and reasons for changes in, net interest.

17. Net interest is a product of both interest rates and the amounts of borrowing and lending. It is desirable for management to provide a commentary about average interest rates, average interest earning assets and average interest-bearing liabilities for the period. In some countries, governments provide assistance to banks by making deposits and other credit facilities available at interest rates which are substantially below market rates. In these cases, management's commentary often discloses the extent of these deposits and facilities and their effect on net income.

Balance Sheet

18. A bank should present a balance sheet that groups assets and liabilities by nature and lists them in an order that reflects their relative liquidity.

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19. ***In addition to the requirements of other International Accounting Standards, the disclosures in the balance sheet or the notes to the financial statements should include, but are not limited to, the following assets and liabilities:***

Assets

Cash and balances with the central bank;

Treasury bills and other bills eligible for rediscounting with the central bank;

Government and other securities held for dealing purposes;

Placements with, and loans and advances to, other banks;

Other money market placements;

Loans and advances to customers; and

Investment securities.

Liabilities

Deposits from other banks;

Other money market deposits;

Amounts owed to other depositors;

Certificates of deposits;

Promissory notes and other liabilities evidenced by paper; and

Other borrowed funds.

20. The most useful approach to the classification of the assets and liabilities of a bank is to group them by their nature and list them in the approximate order of their liquidity; this may equate broadly to their maturities. Current and non-current items are not presented separately because most assets and liabilities of a bank can be realised or settled in the near future.

21. The distinction between balances with other banks and those with other parts of the money market and from other depositors is relevant information because it gives an understanding of a bank's relations with, and dependence on, other banks and the money market. Hence, a bank discloses separately:

IAS 30 (reformatted 1994)

(a) balances with the central bank;

(b) placements with other banks;

(c) other money market placements;

(d) deposits from other banks;

(e) other money market deposits; and

(f) other deposits.

22. A bank generally does not know the holders of its certificates of deposit because they are usually traded on an open market. Hence, a bank discloses separately deposits that have been obtained through the issue of its own certificates of deposit or other negotiable paper.

*23. **The amount at which any asset or liability is stated in the balance sheet should not be offset by the deduction of another liability or asset unless a legal right of set-off exists and the offsetting represents the expectation as to the realisation or settlement of the asset or liability.***

*24. **A bank should disclose the market value of dealing securities and marketable investment securities if these values are different from the carrying amounts in the financial statements.***

25. It is important to distinguish dealing securities from investment securities and from other investments. Dealing securities are marketable securities that are acquired and held with the intention of reselling them in the short term. Investment securities are acquired and held for yield or capital growth purposes and are usually held to maturity. The market values of dealing securities and marketable investment securities are disclosed, in accordance with International Accounting Standard IAS 25, Accounting for Investments, if these values are different from the carrying amounts in the financial statements. It is not appropriate in the financial statements of a bank to account for loans, advances and similar transactions as investments.

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Contingencies and Commitments Including Off Balance Sheet Items

26. ***A bank should disclose the following contingencies and commitments required by International Accounting Standard IAS 10, Contingencies and Events Occurring After the Balance Sheet Date:***

    (a) ***the nature and amount of commitments to extend credit that are irrevocable because they cannot be withdrawn at the discretion of the bank without the risk of incurring significant penalty or expense; and***

    (b) ***the nature and amount of contingencies and commitments arising from off balance sheet items including those relating to:***

        (i) ***direct credit substitutes including general guarantees of indebtedness, bank acceptance guarantees and standby letters of credit serving as financial guarantees for loans and securities;***

        (ii) ***certain transaction-related contingencies including performance bonds, bid bonds, warranties and standby letters of credit related to particular transactions;***

        (iii) ***short-term self-liquidating trade-related contingencies arising from the movement of goods, such as documentary credits where the underlying shipment is used as security;***

        (iv) ***those sale and repurchase agreements not recognised in the balance sheet;***

        (v) ***interest and foreign exchange rate related items including swaps, options and futures; and***

        (vi) ***other commitments, note issuance facilities and revolving underwriting facilities.***

27. International Accounting Standard IAS 10, Contingencies and Events Occurring After the Balance Sheet Date, deals generally with accounting for, and disclosure of, contingencies. The Standard is of particular relevance to banks because banks often become engaged in many types of contingencies and commitments, some revocable and others irrevocable, which are frequently significant in amount and substantially larger than those of other commercial enterprises.

IAS 30 (reformatted 1994)

28. Many banks also enter into transactions that are presently not recognised as assets or liabilities in the balance sheet but which give rise to contingencies and commitments. Such off balance sheet items often represent an important part of the business of a bank and may have a significant bearing on the level of risk to which the bank is exposed. These items may add to, or reduce, other risks, for example by hedging assets or liabilities on the balance sheet. Off balance sheet items may arise from transactions carried out on behalf of customers or from the bank's own trading position.

29. The users of the financial statements need to know about the contingencies and irrevocable commitments of a bank because of the demands they may put on its liquidity and solvency and the inherent possibility of potential losses. Users also require adequate information about the nature and amount of off balance sheet transactions undertaken by a bank.

Maturities of Assets and Liabilities

30. A bank should disclose an analysis of assets and liabilities into relevant maturity groupings based on the remaining period at the balance sheet date to the contractual maturity date.

31. The matching and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the management of a bank. It is unusual for banks ever to be completely matched since business transacted is often of uncertain term and of different types. An unmatched position potentially enhances profitability but can also increase the risk of losses.

32. The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest-bearing liabilities as they mature, are important factors in assessing the liquidity of a bank and its exposure to changes in interest rates and exchange rates. In order to provide information that is relevant for the assessment of its liquidity, a bank discloses, as a minimum, an analysis of assets and liabilities into relevant maturity groupings.

33. The maturity groupings applied to individual assets and liabilities differ between banks and in their appropriateness to particular assets and liabilities. Examples of periods used include the following:

    (a) up to 1 month;

    (b) from 1 month to 3 months;

    (c) from 3 months to 1 year;

    (d) from 1 year to 5 years; and

    (e) from 5 years and over.

    Frequently the periods are combined, for example, in the case of loans and advances, by grouping those under one year and those over one year. When repayment is spread over a period of time, each instalment is allocated to the period in which it is contractually agreed or expected to be paid or received.

34. It is essential that the maturity periods adopted by a bank are the same for assets and liabilities. This makes clear the extent to which the maturities are matched and the consequent dependence of the bank on other sources of liquidity.

35. Maturities could be expressed in terms of:

    (a) the remaining period to the repayment date;

    (b) the original period to the repayment date; or

    (c) the remaining period to the next date at which interest rates may be changed.

    The analysis of assets and liabilities by their remaining periods to the repayment dates provides the best basis to evaluate the liquidity of a bank. A bank may also disclose repayment maturities based on the original period to the repayment date in order to provide information about its funding and business strategy. In addition, a bank may disclose maturity groupings based on the remaining period to the next date at which interest rates may be changed in order to demonstrate its exposure to interest rate risks. Management may also provide, in its commentary on the financial statements, information about interest rate exposure and about the way it manages and controls such exposures.

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36. In many countries, deposits made with a bank may be withdrawn on demand and advances given by a bank may be repayable on demand. However, in practice, these deposits and advances are often maintained for long periods without withdrawal or repayment; hence, the effective date of repayment is later than the contractual date. Nevertheless, a bank discloses an analysis expressed in terms of contractual maturities even though the contractual repayment period is often not the effective period because contractual dates reflect the liquidity risks attaching to the bank's assets and liabilities.

37. Some assets of a bank do not have a contractual maturity date. The period in which these assets are assumed to mature is usually taken as the expected date on which the assets will be realised.

38. The users' evaluation of the liquidity of a bank from its disclosure of maturity groupings is made in the context of local banking practices, including the availability of funds to banks. In some countries, short-term funds are available, in the normal course of business, from the money market or, in an emergency, from the central bank. In other countries, this is not the case.

39. In order to provide users with a full understanding of the maturity groupings, the disclosures in the financial statements may need to be supplemented by information as to the likelihood of repayment within the remaining period. Hence, management may provide, in its commentary on the financial statements, information about the effective periods and about the way it manages and controls the risks and exposures associated with different maturity and interest rate profiles.

Concentrations of Assets, Liabilities and Off Balance Sheet Items

40. A bank should disclose any significant concentrations of its assets, liabilities and off balance sheet items. Such disclosures should be made in terms of geographical areas, customer or industry groups or other concentrations of risk. A bank should also disclose the amount of significant net foreign currency exposures.

41. A bank discloses significant concentrations in the distribution of its assets and in the source of its liabilities because it is a useful indication of the potential risks inherent in the realisation of the assets and the funds available to the bank. Such disclosures are made in terms of geographical areas, customer or industry groups or other concentrations of risk which are appropriate in the circumstances of the bank. A similar analysis and explanation of off balance sheet items is also important. Geographical areas may comprise individual countries, groups of countries or regions within a country; customer disclosures may deal with sectors such as governments, public authorities, and commercial and business enterprises. Such disclosures are made in addition to any segment information required by International Accounting Standard IAS 14, Reporting Financial Information by Segment.

42. The disclosure of significant net foreign currency exposures is also a useful indication of the risk of losses arising from changes in exchange rates.

Losses on Loans and Advances

43. A bank should disclose the following:

(a) the accounting policy which describes the basis on which uncollectable loans and advances are recognised as an expense and written off;

(b) details of the movements in the provision for losses on loans and advances during the period. It should disclose separately the amount recognised as an expense in the period for losses on uncollectable loans and advances, the amount charged in the period for loans and advances written off and the amount credited in the period for loans and advances previously written off that have been recovered;

(c) the aggregate amount of the provision for losses on loans and advances at the balance sheet date; and

(d) the aggregate amount included in the balance sheet for loans and advances on which interest is not being accrued and the basis used to determine the carrying amount of such loans and advances.

*44. **Any amounts set aside in respect of losses on loans and advances in addition to those losses that have been specifically identified or potential losses which experience indicates are present in the portfolio of loans and advances should be accounted for as appropriations of retained earnings. Any credits resulting from the reduction of such amounts result in an increase in retained earnings and are not included in the determination of net profit or loss for the period.***

45. It is inevitable that in the ordinary course of business, banks suffer losses on loans, advances and other credit facilities as a result of their becoming partly or wholly uncollectable. The amount of losses which have been specifically identified is recognised as an expense and deducted from the carrying amount of the appropriate category of loans and advances as a provision for losses on loans and advances. The amount of potential losses not specifically identified but which experience indicates are present in the portfolio of loans and advances is also recognised as an expense and deducted from the total carrying amount of loans and advances as a provision for losses on loans and advances. The assessment of these losses depends on the judgement of management; it is essential, however, that management applies its assessments in a consistent manner from period to period.

46. Local circumstances or legislation may require or allow a bank to set aside amounts for losses on loans and advances in addition to those losses which have been specifically identified and those potential losses which experience indicates are present in the portfolio of loans and advances. Any such amounts set aside represent appropriations of retained earnings and not expenses in determining net profit or loss for the period. Similarly, any credits resulting from the reduction of such amounts result in an increase in retained earnings and are not included in the determination of net profit or loss for the period.

47. Users of the financial statements of a bank need to know the impact that losses on loans and advances have had on the financial position and performance of the bank; this helps them judge the effectiveness with which the bank has employed its resources. Therefore a bank discloses the aggregate amount of the provision for losses on loans and advances at the balance sheet date and the movements in the provision during the period. The movements in the provision, including the amounts previously written off that have been recovered during the period, are shown separately.

48. A bank may decide not to accrue interest on a loan or advance, for example when the borrower is more than a particular period in arrears with respect to the payment of interest or principal. A bank discloses the aggregate amount of loans and advances at the balance sheet date on which interest is not being accrued and the basis used to determine the carrying amount of such loans and advances. It is also desirable that a bank discloses whether it recognises interest income on such loans and advances and the impact which the non-accrual of interest has on its income statement.

49. When loans and advances cannot be recovered, they are written off and charged against the provision for losses. In some cases, they are not written off until all the necessary legal procedures have been completed and the amount of the loss is finally determined. In other cases, they are written off earlier, for example when the borrower has not paid any interest or repaid any principal that was due in a specified period. As the time at which uncollectable loans and advances are written off differs, the gross amount of loans and advances and of the provisions for losses may vary considerably in similar circumstances. As a result, a bank discloses its policy for writing off uncollectable loans and advances.

General Banking Risks

50. Any amounts set aside in respect of general banking risks, including future losses and other unforeseeable risks or contingencies in addition to those for which accrual must be made in accordance with International Accounting Standard IAS 10, Contingencies and Events Occurring After the Balance Sheet Date, should be separately disclosed as appropriations of retained earnings. Any credits resulting from the reduction of such amounts result in an increase in retained earnings and are not included in the determination of net profit or loss for the period.

51. Local circumstances or legislation may require or allow a bank to set aside amounts for general banking risks, including future losses or other unforeseeable risks, in addition to the charges for losses on loans and advances determined in accordance with paragraph 45. A bank may also be required or allowed to set aside amounts for contingencies in addition to those for which accrual is required by International

Accounting Standard IAS 10, Contingencies and Events Occurring After the Balance Sheet Date. These charges may result in the overstatement of liabilities, understatement of assets or undisclosed accruals and provisions. They present the opportunity to distort net income and equity.

52. The income statement cannot present relevant and reliable information about the performance of a bank if net profit or loss for the period includes the effects of undisclosed amounts set aside for general banking risks or additional contingencies, or undisclosed credits resulting from the reversal of such amounts. Similarly, the balance sheet cannot provide relevant and reliable information about the financial position of a bank if the balance sheet includes overstated liabilities, understated assets or undisclosed accruals and provisions.

Assets Pledged as Security

53. ***A bank should disclose the aggregate amount of secured liabilities and the nature and carrying amount of the assets pledged as security.***

54. In some countries, banks are required, either by law or national custom, to pledge assets as security to support certain deposits and other liabilities. The amounts involved are often substantial and so may have a significant impact on the assessment of the financial position of a bank.

Trust Activities

55. Banks commonly act as trustees and in other fiduciary capacities that result in the holding or placing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions. Provided the trustee or similar relationship is legally supported, these assets are not assets of the bank and, therefore, are not included in its balance sheet. If the bank is engaged in significant trust activities, disclosure of that fact and an indication of the extent of those activities is made in its financial statements because of the potential liability if it fails in its fiduciary duties. For this purpose, trust activities do not encompass safe custody functions.

IAS 30 (reformatted 1994)

Related Party Transactions

56. International Accounting Standard IAS 24, Related Party Disclosures, deals generally with the disclosures of related party relationships and transactions between a reporting enterprise and its related parties. In some countries, the law or regulatory authorities prevent or restrict banks entering into transactions with related parties whereas in others such transactions are permitted. International Accounting Standard IAS 24, Related Party Disclosures, is of particular relevance in the presentation of the financial statements of a bank in a country that permits such transactions.

57. Certain transactions between related parties may be effected on different terms from those with unrelated parties. For example, a bank may advance a larger sum or charge lower interest rates to a related party than it would in otherwise identical circumstances to an unrelated party; advances or deposits may be moved between related parties more quickly and with less formality than is possible when unrelated parties are involved. Even when related party transactions arise in the ordinary course of a bank's business, information about such transactions is relevant to the needs of users and its disclosure is required by International Accounting Standard IAS 24, Related Party Disclosures.

58. When a bank has entered into transactions with related parties, it is appropriate to disclose the nature of the related party relationship, the types of transactions, and the elements of transactions necessary for an understanding of the financial statements of the bank. The elements that would normally be disclosed to conform with International Accounting Standard IAS 24, Related Party Disclosures, include a bank's lending policy to related parties and, in respect of related party transactions, the amount included in or the proportion of:

    (a) each of loans and advances, deposits and acceptances and promissory notes; disclosures may include the aggregate amounts outstanding at the beginning and end of the period, as well as advances, deposits, repayments and other changes during the period;

    (b) each of the principal types of income, interest expense and commissions paid;

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(c) the amount of the expense recognised in the period for losses on loans and advances and the amount of the provision at the balance sheet date; and

(d) irrevocable commitments and contingencies and commitments arising from off balance sheet items.

Effective Date

59. ***This International Accounting Standard becomes operative for the financial statements of banks covering periods beginning on or after 1 January 1991.***

International Accounting Standard IAS 32

Financial Instruments: Disclosure and Presentation

The first phase of the Financial Instruments project was completed in March 1995, when the Board approved IAS 32, Financial Instruments: Disclosure and Presentation. IASC plans to publish examples illustrating the application of IAS 32 in early 1996.

The second phase of the project will deal with the other issues dealt with in E48, Financial Instruments (see pages 603 to 730). Those issues include recognition, discontinuance of recognition ("derecognition") and measurement. It will also cover accounting for securitisations and debt defeasance transactions, as well as accounting for financial assets and liabilities used in complex risk management strategies and other hedging transactions. The second phase of the project is the Board's single highest priority.

The Board has decided that the first step in the second phase of the financial instruments project should be to prepare by the end of 1996, a comprehensive discussion paper that:

(a) examines the reasoning and assumptions underlying significant alternative approaches to resolving the major recognition and measurement issues associated with financial instruments; and

(b) sets out proposed principles that will provide the framework for development of specific Standards.

International Accounting Standard

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APPENDIX

IAS 32

International Accounting Standard IAS 32

Financial Instruments: Disclosure and Presentation

The standards, which have been set in bold italic type, should be read in the context of the background material and implementation guidance in this Standard, and in the context of the Preface to International Accounting Standards. International Accounting Standards are not intended to apply to immaterial items (see paragraph 12 of the Preface).

Objective

The dynamic nature of international financial markets has resulted in the widespread use of a variety of financial instruments ranging from traditional primary instruments, such as bonds, to various forms of derivative instruments, such as interest rate swaps. The objective of this Standard is to enhance financial statement users' understanding of the significance of on-balance-sheet and off-balance-sheet financial instruments to an enterprise's financial position, performance and cash flows.

The Standard prescribes certain requirements for presentation of on-balance-sheet financial instruments and identifies the information that should be disclosed about both on-balance-sheet (recognised) and off-balance-sheet (unrecognised) financial instruments. The presentation standards deal with the classification of financial instruments between liabilities and equity, the classification of related interest, dividends, losses and gains, and the circumstances in which financial assets and financial liabilities should be offset. The disclosure standards deal with information about factors that affect the amount, timing and certainty of an enterprise's future cash flows relating to financial instruments and the accounting policies applied to the instruments. In addition, the Standard encourages disclosure of information about the nature and extent of an enterprise's use of financial instruments, the business purposes that they serve, the risks associated with them and management's policies for controlling those risks.

Scope

1. *This Standard should be applied in presenting and disclosing information about all types of financial instruments, both recognised and unrecognised, other than:*

   (a) *interests in subsidiaries, as defined in International Accounting Standard IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries;*

   (b) *interests in associates, as defined in International Accounting Standard IAS 28, Accounting for Investments in Associates;*

   (c) *interests in joint ventures, as defined in International Accounting Standard IAS 31, Financial Reporting of Interests in Joint Ventures;*

   (d) *employers' and plans' obligations for post–employment benefits of all types, including retirement benefits as described in International Accounting Standard IAS 19, Retirement Benefit Costs, and International Accounting Standard IAS 26, Accounting and Reporting by Retirement Benefit Plans;*

   (e) *employers' obligations under employee stock option and stock purchase plans; and*

   (f) *obligations arising under insurance contracts.*

2. Although this Standard does not apply to an enterprise's interests in subsidiaries, it does apply to all financial instruments included in the consolidated financial statements of a parent, regardless of whether those instruments are held or issued by the parent or by a subsidiary. Similarly, the Standard applies to financial instruments held or issued by a joint venture and included in the financial statements of a venturer either directly or through proportionate consolidation.

3. For purposes of this Standard, an insurance contract is a contract that exposes the insurer to identified risks of loss from events or circumstances occurring or discovered within a specified period, including death (in the case of an annuity, the survival of the annuitant), sickness, disability, property damage, injury to others and business interruption. However, the provisions of this Standard apply when a financial instrument takes the form of an insurance contract but

principally involves the transfer of financial risks (see paragraph 43), for example, some types of financial reinsurance and guaranteed investment contracts issued by insurance and other enterprises. Enterprises that have obligations under insurance contracts are encouraged to consider the appropriateness of applying the provisions of this Standard in presenting and disclosing information about such obligations.

4. Other International Accounting Standards specific to certain types of financial instruments contain additional presentation and disclosure requirements. For example, International Accounting Standard IAS 17, Accounting for Leases, and International Accounting Standard IAS 26, Accounting and Reporting by Retirement Benefit Plans, incorporate specific disclosure requirements relating to finance leases and retirement benefit plan investments, respectively. In addition, some requirements of other International Accounting Standards, particularly International Accounting Standard IAS 5, Information to be Disclosed in Financial Statements, and International Accounting Standard IAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions, apply to financial instruments.

Definitions

5. *The following terms are used in this Standard with the meanings specified:*

A financial instrument is any contract that gives rise to both a financial asset of one enterprise and a financial liability or equity instrument of another enterprise.

A financial asset is any asset that is:

(a) cash;

(b) a contractual right to receive cash or another financial asset from another enterprise;

(c) a contractual right to exchange financial instruments with another enterprise under conditions that are potentially favourable; or

(d) an equity instrument of another enterprise.

A financial liability is any liability that is a contractual obligation:

(a) to deliver cash or another financial asset to another enterprise; or

(b) to exchange financial instruments with another enterprise under conditions that are potentially unfavourable.

An equity instrument is any contract that evidences a residual interest in the assets of an enterprise after deducting all of its liabilities.

Monetary financial assets and financial liabilities (also referred to as monetary financial instruments) are financial assets and financial liabilities to be received or paid in fixed or determinable amounts of money.

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Market value is the amount obtainable from the sale, or payable on the acquisition, of a financial instrument in an active market.

6. In this Standard, the terms "contract" and "contractual" refer to an agreement between two or more parties that has clear economic consequences that the parties have little, if any, discretion to avoid, usually because the agreement is enforceable at law. Contracts, and thus financial instruments, may take a variety of forms and need not be in writing.

7. For purposes of the definitions in paragraph 5, the term "enterprise" includes individuals, partnerships, incorporated bodies and government agencies.

8. Parts of the definitions of a financial asset and a financial liability include the terms financial asset and financial instrument, but the definitions are not circular. When there is a contractual right or obligation to exchange financial instruments, the instruments to be exchanged give rise to financial assets, financial liabilities, or equity instruments. A chain of contractual rights or obligations may be established but it ultimately leads to the receipt or payment of cash or to the acquisition or issuance of an equity instrument.

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9. Financial instruments include both primary instruments, such as receivables, payables and equity securities, and derivative instruments, such as financial options, futures and forwards, interest rate swaps and currency swaps. Derivative financial instruments, whether recognised or unrecognised, meet the definition of a financial instrument and, accordingly, are subject to this Standard.

10. Derivative financial instruments create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial risks inherent in an underlying primary financial instrument. Derivative instruments do not result in a transfer of the underlying primary financial instrument on inception of the contract and such a transfer does not necessarily take place on maturity of the contract.

11. Physical assets such as inventories, property, plant and equipment, leased assets and intangible assets such as patents and trademarks are not financial assets. Control of such physical and intangible assets creates an opportunity to generate an inflow of cash or other assets but it does not give rise to a present right to receive cash or other financial assets.

12. Assets, such as prepaid expenses, for which the future economic benefit is the receipt of goods or services rather than the right to receive cash or another financial asset are not financial assets. Similarly, items such as deferred revenue and most warranty obligations are not financial liabilities because the probable outflow of economic benefits associated with them is the delivery of goods and services rather than cash or another financial asset.

13. Liabilities or assets that are not contractual in nature, such as income taxes that are created as a result of statutory requirements imposed by governments, are not financial liabilities or financial assets. Accounting for income taxes is dealt with in International Accounting Standard IAS 12, Accounting for Taxes on Income.

14. Contractual rights and obligations that do not involve the transfer of a financial asset do not fall within the scope of the definition of a financial instrument. For example, some contractual rights (obligations), such as those that arise under a commodity futures contract, can be settled only by the receipt (delivery) of non-financial assets. Similarly, contractual rights (obligations) such as those that arise under an operating lease for use of a physical asset can be settled only by the receipt (delivery) of services. In both cases, the contractual right of one party to receive a non-financial asset or service and the corresponding obligation of the

other party do not establish a present right or obligation of either party to receive, deliver or exchange a financial asset.

15. The ability to exercise a contractual right or the requirement to satisfy a contractual obligation may be absolute, or it may be contingent on the occurrence of a future event. For example, a financial guarantee is a contractual right of the lender to receive cash from the guarantor, and a corresponding contractual obligation of the guarantor to pay the lender, if the borrower defaults. The contractual right and obligation exist because of a past transaction or event (assumption of the guarantee), even though the lender's ability to exercise its right and the requirement for the guarantor to perform under its obligation are both contingent on a future act of default by the borrower. A contingent right and obligation meet the definition of a financial asset and a financial liability, even though many such assets and liabilities do not qualify for recognition in financial statements.

16. An obligation of an enterprise to issue or deliver its own equity instruments, such as a share option or warrant, is itself an equity instrument, not a financial liability, since the enterprise is not obliged to deliver cash or another financial asset. Similarly, the cost incurred by an enterprise to purchase a right to re-acquire its own equity instruments from another party is a deduction from its equity, not a financial asset.

17. The minority interest that may arise on an enterprise's balance sheet from consolidating a subsidiary is not a financial liability or an equity instrument of the enterprise. In consolidated financial statements, an enterprise presents the interests of other parties in the equity and income of its subsidiaries in accordance with International Accounting Standard IAS 27, Consolidated Financial Statements and Accounting for Investments in Subsidiaries. Accordingly, a financial instrument classified as an equity instrument by a subsidiary is eliminated on consolidation when held by the parent, or presented by the parent in the consolidated balance sheet as a minority interest separate from the equity of its own shareholders. A financial instrument classified as a financial liability by a subsidiary remains a liability in the parent's consolidated balance sheet unless eliminated on consolidation as an intragroup balance. The accounting treatment by the parent on consolidation does not affect the basis of presentation by the subsidiary in its financial statements.

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Presentation

Liabilities and Equity

18. ***The issuer of a financial instrument should classify the instrument, or its component parts, as a liability or as equity in accordance with the substance of the contractual arrangement on initial recognition and the definitions of a financial liability and an equity instrument.***

19. The substance of a financial instrument, rather than its legal form, governs its classification on the issuer's balance sheet. While substance and legal form are commonly consistent, this is not always the case. For example, some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. The classification of an instrument is made on the basis of an assessment of its substance when it is first recognised. That classification continues at each subsequent reporting date until the financial instrument is removed from the enterprise's balance sheet.

20. The critical feature in differentiating a financial liability from an equity instrument is the existence of a contractual obligation on one party to the financial instrument (the issuer) either to deliver cash or another financial asset to the other party (the holder) or to exchange another financial instrument with the holder under conditions that are potentially unfavourable to the issuer. When such a contractual obligation exists, that instrument meets the definition of a financial liability regardless of the manner in which the contractual obligation will be settled. A restriction on the ability of the issuer to satisfy an obligation, such as lack of access to foreign currency or the need to obtain approval for payment from a regulatory authority, does not negate the issuer's obligation or the holder's right under the instrument.

21. When a financial instrument does not give rise to a contractual obligation on the part of the issuer to deliver cash or another financial asset or to exchange another financial instrument under conditions that are potentially unfavourable, it is an equity instrument. Although the holder of an equity instrument may be entitled to receive a pro rata share of any dividends or other distributions out of equity, the issuer does not have a contractual obligation to make such distributions.

22. When a preferred share provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date or gives the holder the right to require the issuer to redeem the share at or after a particular date for a fixed or determinable amount, the instrument meets the definition of a financial liability and is classified as such. A preferred share that does not establish such a contractual obligation explicitly may establish it indirectly through its terms and conditions. For example, a preferred share that does not provide for mandatory redemption or redemption at the option of the holder may have a contractually provided accelerating dividend such that, within the foreseeable future, the dividend yield is scheduled to be so high that the issuer will be economically compelled to redeem the instrument. In these circumstances, classification as a financial liability is appropriate because the issuer has little, if any, discretion to avoid redeeming the instrument. Similarly, if a financial instrument labelled as a share gives the holder an option to require redemption upon the occurrence of a future event that is highly likely to occur, classification as a financial liability on initial recognition reflects the substance of the instrument.

Classification of Compound Instruments by the Issuer

23. ***The issuer of a financial instrument that contains both a liability and an equity element should classify the instrument's component parts separately in accordance with paragraph 18.***

24. This Standard requires the separate presentation on an issuer's balance sheet of liability and equity elements created by a single financial instrument. It is more a matter of form than substance that both liabilities and equity interests are created by a single financial instrument rather than two or more separate instruments. An issuer's financial position is more faithfully represented by separate presentation of liability and equity components contained in a single instrument according to their nature.

25. For purposes of balance sheet presentation, an issuer recognises separately the component parts of a financial instrument that creates a primary financial liability of the issuer and grants an option to the holder of the instrument to convert it into an equity instrument of the issuer. A bond or similar instrument convertible by the holder into common shares of the issuer is an example of such an instrument. From the perspective of the issuer, such an instrument comprises two components: a financial

liability (a contractual arrangement to deliver cash or other financial assets) and an equity instrument (a call option granting the holder the right, for a specified period of time, to convert into common shares of the issuer). The economic effect of issuing such an instrument is substantially the same as issuing simultaneously a debt instrument with an early settlement provision and warrants to purchase common shares, or issuing a debt instrument with detachable share purchase warrants. Accordingly, in all cases, the issuer presents the liability and equity elements separately on its balance sheet.

26. Classification of the liability and equity components of a convertible instrument is not revised as a result of a change in the likelihood that a conversion option will be exercised, even when exercise of the option may appear to have become economically advantageous to some holders. Holders may not always act in the manner that might be expected because, for example, the tax consequences resulting from conversion may differ among holders. Furthermore, the likelihood of conversion will change from time to time. The issuer's obligation to make future payments remains outstanding until it is extinguished through conversion, the maturity of the instrument or some other transaction.

27. A financial instrument may contain components that are neither financial liabilities nor equity instruments of the issuer. For example, an instrument may give the holder the right to receive a non-financial asset such as a commodity in settlement and an option to exchange that right for shares of the issuer. The issuer recognises and presents the equity instrument (the exchange option) separately from the liability components of the compound instrument, whether the liabilities are financial or non-financial.

28. This Standard does not deal with measurement of financial assets, financial liabilities and equity instruments and does not therefore prescribe any particular method for assigning a carrying amount to liability and equity elements contained in a single instrument. Approaches that might be followed include:

(a) assigning to the less easily measurable component (often an equity instrument), the residual amount after deducting from the instrument as a whole the amount separately determined for the component that is more easily measurable; and

(b) measuring the liability and equity components separately and, to the extent necessary, adjusting these amounts on a pro rata basis so that the sum of the components equals the amount of the instrument as a whole.

The sum of the carrying amounts assigned to the liability and equity components on initial recognition is always equal to the carrying amount that would be ascribed to the instrument as a whole. No gain or loss arises from recognising and presenting the components of the instrument separately.

29. Under the first approach described in paragraph 28, the issuer of a bond convertible into common shares first determines the carrying amount of the financial liability by discounting the stream of future payments of interest and principal at the prevailing market rate for a similar liability that does not have an associated equity component. The carrying amount of the equity instrument represented by the option to convert the instrument into common shares may then be determined by deducting the carrying amount of the financial liability from the amount of the compound instrument as a whole. Under the second approach, the issuer determines the value of the option directly either by reference to the fair value of a similar option, if one exists, or by using an option pricing model. The value determined for each component is then adjusted on a pro-rata basis to the extent necessary to ensure that the sum of the carrying amounts assigned to the components equals the amount of the consideration received for the convertible bond.

Interest, Dividends, Losses and Gains

30. Interest, dividends, losses and gains relating to a financial instrument, or a component part, classified as a financial liability should be reported in the income statement as expense or income. Distributions to holders of a financial instrument classified as an equity instrument should be debited by the issuer directly to equity.

31. The classification of a financial instrument in the balance sheet determines whether interest, dividends, losses and gains relating to that instrument are classified as expenses or income and reported in the income statement. Thus, dividend payments on shares classified as liabilities are classified as expenses in the same way as interest on a bond and reported in the income statement. Similarly, gains and losses

associated with redemptions or refinancings of instruments classified as liabilities are reported in the income statement, while redemptions or refinancings of instruments classified as equity of the issuer are reported as movements in equity.

32. Dividends classified as an expense may be presented in the income statement either with interest on other liabilities or as a separate item. Disclosure of interest and dividends is subject to the requirements of International Accounting Standard IAS 5, Information to be Disclosed in Financial Statements, and International Accounting Standard IAS 30, Disclosures in the Financial Statements of Banks and Similar Financial Institutions. In some circumstances, because of significant differences between interest and dividends with respect to matters such as tax deductibility, it is desirable to disclose them separately within the income statement. Disclosures of the amounts of tax effects are made in accordance with International Accounting Standard IAS 12, Accounting for Taxes on Income.

Offsetting of a Financial Asset and a Financial Liability

33. A financial asset and a financial liability should be offset and the net amount reported in the balance sheet when an enterprise:

(a) has a legally enforceable right to set off the recognised amounts; and

(b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously.

34. This standard requires the presentation of financial assets and financial liabilities on a net basis when this reflects an enterprise's expected future cash flows from settling two or more separate financial instruments. When an enterprise has the right to receive or pay a single net amount and intends to do so, it has, in effect, only a single financial asset or financial liability. In other circumstances, financial assets and financial liabilities are presented separately from each other consistent with their characteristics as resources or obligations of the enterprise.

35. Offsetting a recognised financial asset and a recognised financial liability and presenting the net amount differs from ceasing to recognise a financial asset or a financial liability. While offsetting does not give rise

to recognition of a gain or a loss, ceasing to recognise a financial instrument not only results in the removal of the previously recognised item from the balance sheet but may also result in recognition of a gain or a loss.

36. A right of set-off is a debtor's legal right, by contract or otherwise, to settle or otherwise eliminate all or a portion of an amount due to a creditor by applying against that amount an amount due from the creditor. In unusual circumstances, a debtor may have a legal right to apply an amount due from a third party against the amount due to a creditor provided that there is an agreement among the three parties that clearly establishes the debtor's right of set-off. Since the right of set-off is a legal right, the conditions supporting the right may vary from one legal jurisdiction to another and care must be taken to establish which laws apply to the relationships between the parties.

37. The existence of an enforceable right to set off a financial asset and a financial liability affects the rights and obligations associated with a financial asset and a financial liability and may affect significantly an enterprise's exposure to credit and liquidity risk. However, the existence of the right, by itself, is not a sufficient basis for offsetting. In the absence of an intention to exercise the right or to settle simultaneously, the amount and timing of an enterprise's future cash flows are not affected. When an enterprise does intend to exercise the right or to settle simultaneously, presentation of the asset and liability on a net basis reflects more appropriately the amounts and timing of the expected future cash flows, as well as the risks to which those cash flows are exposed. An intention by one or both parties to settle on a net basis without the legal right to do so is not sufficient to justify offsetting since the rights and obligations associated with the individual financial asset and financial liability remain unaltered.

38. An enterprise's intentions with respect to settlement of particular assets and liabilities may be influenced by its normal business practices, the requirements of the financial markets and other circumstances that may limit the ability to settle net or to settle simultaneously. When an enterprise has a right of set-off but does not intend to settle net or to realise the asset and settle the liability simultaneously, the effect of the right on the enterprise's credit risk exposure is disclosed in accordance with the standard in paragraph 66.

39. Simultaneous settlement of two financial instruments may occur through, for example, the operation of a clearing house in an organised financial market or a face-to-face exchange. In these circumstances the cash flows are, in effect, equivalent to a single net amount and there is no exposure to credit or liquidity risk. In other circumstances, an enterprise may settle two instruments by receiving and paying separate amounts, becoming exposed to credit risk for the full amount of the asset or liquidity risk for the full amount of the liability. Such risk exposures may be significant even though relatively brief. Accordingly, realisation of a financial asset and settlement of a financial liability are considered simultaneous only when the transactions occur at the same moment.

40. The conditions set out in paragraph 33 are generally not satisfied and offsetting is usually inappropriate when:

    (a) several different financial instruments are used to emulate the features of a single financial instrument (i.e. a "synthetic instrument");

    (b) financial assets and financial liabilities arise from financial instruments having the same primary risk exposure (for example, assets and liabilities within a portfolio of forward contracts or other derivative instruments) but involve different counterparties;

    (c) financial or other assets are pledged as collateral for non-recourse financial liabilities;

    (d) financial assets are set aside in trust by a debtor for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation (for example, a sinking fund arrangement); or

    (e) obligations incurred as a result of events giving rise to losses are expected to be recovered from a third party by virtue of a claim made under an insurance policy.

41. An enterprise that undertakes a number of financial instrument transactions with a single counterparty may enter into a "master netting arrangement" with that counterparty. Such an agreement provides for a single net settlement of all financial instruments covered by the agreement in the event of default on, or termination of, any one contract. These arrangements are commonly used by financial institutions to provide protection against loss in the event of bankruptcy or other events

that result in a counterparty being unable to meet its obligations. A master netting arrangement commonly creates a right of set-off that becomes enforceable and affects the realisation or settlement of individual financial assets and financial liabilities only following a specified event of default or in other circumstances not expected to arise in the normal course of business. A master netting arrangement does not provide a basis for offsetting unless both of the criteria in paragraph 33 are satisfied. When financial assets and financial liabilities subject to a master netting arrangement are not offset, the effect of the arrangement on an enterprise's exposure to credit risk is disclosed in accordance with paragraph 66.

Disclosure

42. The purpose of the disclosures required by this Standard is to provide information that will enhance understanding of the significance of on-balance-sheet and off-balance-sheet financial instruments to an enterprise's financial position, performance and cash flows and assist in assessing the amounts, timing and certainty of future cash flows associated with those instruments. In addition to providing specific information about particular financial instrument balances and transactions, enterprises are encouraged to provide a discussion of the extent to which financial instruments are used, the associated risks and the business purposes served. A discussion of management's policies for controlling the risks associated with financial instruments, including policies on matters such as hedging of risk exposures, avoidance of undue concentrations of risk and requirements for collateral to mitigate credit risks, provides a valuable additional perspective that is independent of the specific instruments outstanding at a particular time. Some enterprises provide such information in a commentary that accompanies their financial statements rather than as part of the financial statements.

43. Transactions in financial instruments may result in an enterprise's assuming or transferring to another party one or more of the financial risks described below. The required disclosures provide information that assists users of financial statements in assessing the extent of risk related to both recognised and unrecognised financial instruments.

    (a) Price risk — There are three types of price risk: currency risk, interest rate risk and market risk.

(i) Currency risk is the risk that the value of a financial instrument will fluctuate due to changes in foreign exchange rates.

(ii) Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates.

(iii) Market risk is the risk that the value of a financial instrument will fluctuate as a result of changes in market prices whether those changes are caused by factors specific to the individual security or its issuer or factors affecting all securities traded in the market.

The term "price risk" embodies not only the potential for loss but also the potential for gain.

(b) Credit risk — Credit risk is the risk that one party to a financial instrument will fail to discharge an obligation and cause the other party to incur a financial loss.

(c) Liquidity risk — Liquidity risk, also referred to as funding risk, is the risk that an enterprise will encounter difficulty in raising funds to meet commitments associated with financial instruments. Liquidity risk may result from an inability to sell a financial asset quickly at close to its fair value.

(d) Cash flow risk — Cash flow risk is the risk that future cash flows associated with a monetary financial instrument will fluctuate in amount. In the case of a floating rate debt instrument, for example, such fluctuations result in a change in the effective interest rate of the financial instrument, usually without a corresponding change in its fair value.

44. The standards do not prescribe either the format of the information required to be disclosed or its location within the financial statements. With regard to recognised financial instruments, to the extent that the required information is presented on the face of the balance sheet, it is not necessary for it to be repeated in the notes to the financial statements. With regard to unrecognised financial instruments, however, information in notes or supplementary schedules is the primary means of disclosure. Disclosures may include a combination of narrative descriptions and specific quantified data, as appropriate to the nature of the instruments and their relative significance to the enterprise.

45. Determination of the level of detail to be disclosed about particular financial instruments is a matter for the exercise of judgement taking into account the relative significance of those instruments. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring significant information as a result of too much aggregation. For example, when an enterprise is party to large numbers of financial instruments with similar characteristics and no one contract is individually significant, summarised information by reference to particular classes of instruments is appropriate. On the other hand, specific information about an individual instrument may be important when that instrument represents, for example, a significant element in an enterprise's capital structure.

46. Management of an enterprise groups financial instruments into classes that are appropriate to the nature of the information to be disclosed, taking into account matters such as the characteristics of the instruments, whether they are recognised or unrecognised and, if they are recognised, the measurement basis that has been applied. In general, classes are determined on a basis that distinguishes items carried on a cost basis from items carried at fair value. When amounts disclosed in notes or supplementary schedules relate to recognised assets and liabilities, sufficient information is provided to permit a reconciliation to relevant line items on the balance sheet. When an enterprise is a party to financial instruments not dealt with by this Standard, such as obligations under retirement benefit plans or insurance contracts, these instruments constitute a class or classes of financial assets or financial liabilities disclosed separately from those dealt with by this Standard.

Terms, Conditions and Accounting Policies

47. For each class of financial asset, financial liability and equity instrument, both recognised and unrecognised, an enterprise should disclose:

(a) information about the extent and nature of the financial instruments, including significant terms and conditions that may affect the amount, timing and certainty of future cash flows; and

(b) the accounting policies and methods adopted, including the criteria for recognition and the basis of measurement applied.

IAS 32

48. The contractual terms and conditions of a financial instrument are an important factor affecting the amount, timing and certainty of future cash receipts and payments by the parties to the instrument. When recognised and unrecognised instruments are important, either individually or as a class, in relation to the current financial position of an enterprise or its future operating results, their terms and conditions are disclosed. If no single instrument is individually significant to the future cash flows of a particular enterprise, the essential characteristics of the instruments are described by reference to appropriate groupings of like instruments.

49. When financial instruments held or issued by an enterprise, either individually or as a class, create a potentially significant exposure to the risks described in paragraph 43, terms and conditions that may warrant disclosure include:

   (a) the principal, stated, face or other similar amount which, for some derivative instruments, such as interest rate swaps, may be the amount (referred to as the notional amount) on which future payments are based;

   (b) the date of maturity, expiry or execution;

   (c) early settlement options held by either party to the instrument, including the period in which, or date at which, the options may be exercised and the exercise price or range of prices;

   (d) options held by either party to the instrument to convert the instrument into, or exchange it for, another financial instrument or some other asset or liability, including the period in which, or date at which, the options may be exercised and the conversion or exchange ratio(s);

   (e) the amount and timing of scheduled future cash receipts or payments of the principal amount of the instrument, including instalment repayments and any sinking fund or similar requirements;

   (f) stated rate or amount of interest, dividend or other periodic return on principal and the timing of payments;

   (g) collateral held, in the case of a financial asset, or pledged, in the case of a financial liability;

   (h) in the case of an instrument for which cash flows are denominated in a currency other than the enterprise's reporting currency, the currency in which receipts or payments are required;

(i) in the case of an instrument that provides for an exchange, information described in items (a) to (h) for the instrument to be acquired in the exchange; and

(j) any condition of the instrument or an associated covenant that, if contravened, would significantly alter any of the other terms (for example, a maximum debt-to-equity ratio in a bond covenant that, if contravened, would make the full principal amount of the bond due and payable immediately).

50. When the balance sheet presentation of a financial instrument differs from the instrument's legal form, it is desirable for an enterprise to explain in the notes to the financial statements the nature of the instrument.

51. The usefulness of information about the extent and nature of financial instruments is enhanced when it highlights any relationships between individual instruments that may affect the amount, timing or certainty of the future cash flows of an enterprise. For example, it is important to disclose hedging relationships such as might exist when an enterprise holds an investment in shares for which it has purchased a put option. Similarly, it is important to disclose relationships between the components of "synthetic instruments" such as fixed rate debt created by borrowing at a floating rate and entering into a floating to fixed interest rate swap. In each case, an enterprise presents the individual financial assets and financial liabilities in its balance sheet according to their nature, either separately or in the class of financial asset or financial liability to which they belong. The extent to which a risk exposure is altered by the relationships among the assets and liabilities may be apparent to financial statement users from information of the type described in paragraph 49 but in some circumstances further disclosure is necessary.

52. The existence of alternative accounting treatments for financial instruments, such as those permitted by International Accounting Standard IAS 25, Accounting for Investments, makes it particularly important for enterprises to disclose their accounting policies. In accordance with International Accounting Standard IAS 1, Disclosure of Accounting Policies, an enterprise provides clear and concise disclosure of all significant accounting policies, including both the general principles adopted and the method of applying those principles to

significant transactions and circumstances arising in the enterprise's business. In the case of financial instruments, such disclosure includes:

(a) the criteria applied in determining when to recognise a financial asset or financial liability on the balance sheet and when to cease to recognise it;

(b) the basis of measurement applied to financial assets and financial liabilities both on initial recognition and subsequently; and

(c) the basis on which income and expense arising from financial assets and financial liabilities is recognised and measured.

53. Types of transactions for which it may be necessary to disclose the relevant accounting policies include:

(a) transfers of financial assets when there is a continuing interest in, or involvement with, the assets by the transferor, such as securitisations of financial assets, repurchase agreements and reverse repurchase agreements;

(b) transfers of financial assets to a trust for the purpose of satisfying liabilities when they mature without the obligation of the transferor being discharged at the time of the transfer, such as an in-substance defeasance trust;

(c) acquisition or issuance of separate financial instruments as part of a series of transactions designed to synthesise the effect of acquiring or issuing a single instrument;

(d) acquisition or issuance of financial instruments as hedges of risk exposures; and

(e) acquisition or issuance of monetary financial instruments bearing a stated interest rate that differs from the prevailing market rate at the date of issue.

54. To provide adequate information for users of financial statements to understand the basis on which financial assets and financial liabilities have been measured, disclosures of accounting policies indicate not only whether cost, fair value or some other basis of measurement has been applied to a specific class of asset or liability but also the method of applying that basis. For example, for financial instruments carried on the cost basis, an enterprise may be required to disclose how it accounts for:

(a) costs of acquisition or issuance;

(b) premiums and discounts on monetary financial assets and financial liabilities;

(c) changes in the estimated amount of determinable future cash flows associated with a monetary financial instrument such as a bond indexed to a commodity price;

(d) changes in circumstances that result in significant uncertainty about the timely collection of all contractual amounts due from monetary financial assets;

(e) declines in the fair value of financial assets below their carrying amount; and

(f) restructured financial liabilities.

For financial assets and financial liabilities carried at fair value, an enterprise indicates whether carrying amounts are determined from quoted market prices, independent appraisals, discounted cash flow analysis or another appropriate method, and discloses any significant assumptions made in applying those methods.

55. An enterprise discloses the basis for reporting in the income statement realised and unrealised gains and losses, interest and other items of income and expense associated with financial assets and financial liabilities. This disclosure includes information about the basis on which income and expense arising from financial instruments held for hedging purposes are recognised. When an enterprise presents income and expense items on a net basis even though the corresponding financial assets and financial liabilities on the balance sheet have not been offset, the reason for that presentation is disclosed if the effect is significant.

Interest Rate Risk

56. ***For each class of financial asset and financial liability, both recognised and unrecognised, an enterprise should disclose information about its exposure to interest rate risk, including:***

(a) contractual repricing or maturity dates, whichever dates are earlier; and

(b) effective interest rates, when applicable.

IAS 32

57. An enterprise provides information concerning its exposure to the effects of future changes in the prevailing level of interest rates. Changes in market interest rates have a direct effect on the contractually determined cash flows associated with some financial assets and financial liabilities (cash flow risk) and on the fair value of others (price risk).

58. Information about maturity dates, or repricing dates when they are earlier, indicates the length of time for which interest rates are fixed and information about effective interest rates indicates the levels at which they are fixed. Disclosure of this information provides financial statement users with a basis for evaluating the interest rate price risk to which an enterprise is exposed and thus the potential for gain or loss. For instruments that reprice to a market rate of interest before maturity, disclosure of the period until the next repricing is more important than disclosure of the period to maturity.

59. To supplement the information about contractual repricing and maturity dates, an enterprise may elect to disclose information about expected repricing or maturity dates when those dates differ significantly from the contractual dates. Such information may be particularly relevant when, for example, an enterprise is able to predict, with reasonable reliability, the amount of fixed rate mortgage loans that will be repaid prior to maturity and it uses this data as the basis for managing its interest rate risk exposure. The additional information includes disclosure of the fact that it is based on management's expectations of future events and explains the assumptions made about repricing or maturity dates and how those assumptions differ from the contractual dates.

60. An enterprise indicates which of its financial assets and financial liabilities are:

(a) exposed to interest rate price risk, such as monetary financial assets and financial liabilities with a fixed interest rate;

(b) exposed to interest rate cash flow risk, such as monetary financial assets and financial liabilities with a floating interest rate that is reset as market rates change; and

(c) not exposed to interest rate risk, such as some investments in equity securities.

61. The effective interest rate (effective yield) of a monetary financial instrument is the rate that, when used in a present value calculation, results in the carrying amount of the instrument. The present value calculation applies the interest rate to the stream of future cash receipts or payments from the reporting date to the next repricing (maturity) date and to the expected carrying amount (principal amount) at that date. The rate is a historical rate for a fixed rate instrument carried at amortised cost and a current market rate for a floating rate instrument or an instrument carried at fair value. The effective interest rate is sometimes termed the level yield to maturity or to the next repricing date, and is the internal rate of return of the instrument for that period.

62. The requirement in paragraph 56(b) applies to bonds, notes and similar monetary financial instruments involving future payments that create a return to the holder and a cost to the issuer reflecting the time value of money. The requirement does not apply to financial instruments such as non-monetary and derivative instruments that do not bear a determinable effective interest rate. For example, while instruments such as interest rate derivatives, including swaps, forward rate agreements and options, are exposed to price or cash flow risk from changes in market interest rates, disclosure of an effective interest rate is not relevant. However, when providing effective interest rate information, an enterprise discloses the effect on its interest rate risk exposure of hedging or "conversion" transactions such as interest rate swaps.

63. An enterprise may retain an exposure to the interest rate risks associated with financial assets removed from its balance sheet as a result of a transaction such as a securitisation. Similarly, it may become exposed to interest rate risks as a result of a transaction in which no financial asset or financial liability is recognised on its balance sheet, such as a commitment to lend funds at a fixed interest rate. In such circumstances, the enterprise discloses information that will permit financial statement users to understand the nature and extent of its exposure. In the case of a securitisation or similar transfer of financial assets, this information normally includes the nature of the assets transferred, their stated principal, interest rate and term to maturity, and the terms of the transaction giving rise to the retained exposure to interest rate risk. In the case of a commitment to lend funds, the disclosure normally includes the stated principal, interest rate and term to maturity of the amount to be lent and the significant terms of the transaction giving rise to the exposure to risk.

IAS 32

64. The nature of an enterprise's business and the extent of its activity in financial instruments will determine whether information about interest rate risk is presented in narrative form, in tables, or by using a combination of the two. When an enterprise has a significant number of financial instruments exposed to interest rate price or cash flow risks, it may adopt one or more of the following approaches to presenting information.

   (a) The carrying amounts of financial instruments exposed to interest rate price risk may be presented in tabular form, grouped by those that are contracted to mature or be repriced:

      (i) within one year of the balance sheet date;

      (ii) more than one year and less than five years from the balance sheet date; and

      (iii) five years or more from the balance sheet date.

   (b) When the performance of an enterprise is significantly affected by the level of its exposure to interest rate price risk or changes in that exposure, more detailed information is desirable. An enterprise such as a bank may disclose, for example, separate groupings of the carrying amounts of financial instruments contracted to mature or be repriced:

      (i) within one month of the balance sheet date;

      (ii) more than one and less than three months from the balance sheet date; and

      (iii) more than three and less than twelve months from the balance sheet date.

   (c) Similarly, an enterprise may indicate its exposure to interest rate cash flow risk through a table indicating the aggregate carrying amount of groups of floating rate financial assets and financial liabilities maturing within various future time periods.

   (d) Interest rate information may be disclosed for individual financial instruments or weighted average rates or a range of rates may be presented for each class of financial instrument. An enterprise groups instruments denominated in different currencies or having substantially different credit risks into separate classes when these factors result in instruments having substantially different effective interest rates.

65. In some circumstances, an enterprise may be able to provide useful information about its exposure to interest rate risks by indicating the effect of a hypothetical change in the prevailing level of market interest rates on the fair value of its financial instruments and future earnings and cash flows. Such interest rate sensitivity information may be based on an assumed 1% change in market interest rates occurring at the balance sheet date. The effects of a change in interest rates includes changes in interest income and expense relating to floating rate financial instruments and gains or losses resulting from changes in the fair value of fixed rate instruments. The reported interest rate sensitivity may be restricted to the direct effects of an interest rate change on interest-bearing financial instruments on hand at the balance sheet date since the indirect effects of a rate change on financial markets and individual enterprises cannot normally be predicted reliably. When disclosing interest rate sensitivity information, an enterprise indicates the basis on which it has prepared the information, including any significant assumptions.

Credit Risk

66. ***For each class of financial asset, both recognised and unrecognised, an enterprise should disclose information about its exposure to credit risk, including:***

   (a) ***the amount that best represents its maximum credit risk exposure at the balance sheet date, without taking account of the fair value of any collateral, in the event other parties fail to perform their obligations under financial instruments; and***

   (b) ***significant concentrations of credit risk.***

67. An enterprise provides information relating to credit risk to permit users of its financial statements to assess the extent to which failures by counterparties to discharge their obligations could reduce the amount of future cash inflows from financial assets on hand at the balance sheet date. Such failures give rise to a financial loss recognised in an enterprise's income statement. Paragraph 66 does not require an enterprise to disclose an assessment of the probability of losses arising in the future.

68. The purposes of disclosing amounts exposed to credit risk without regard to potential recoveries from realisation of collateral ("an enterprise's maximum credit risk exposure") are:

(a) to provide users of financial statements with a consistent measure of the amount exposed to credit risk for both recognised and unrecognised financial assets; and

(b) to take into account the possibility that the maximum exposure to loss may differ from the carrying amount of a recognised financial asset or the fair value of an unrecognised financial asset that is otherwise disclosed in the financial statements.

69. In the case of recognised financial assets exposed to credit risk, the carrying amount of the assets in the balance sheet, net of any applicable provisions for loss, usually represents the amount exposed to credit risk. For example, in the case of an interest rate swap carried at fair value, the maximum exposure to loss at the balance sheet date is normally the carrying amount since it represents the cost, at current market rates, of replacing the swap in the event of default. In these circumstances, no additional disclosure beyond that provided on the balance sheet is necessary. On the other hand, as illustrated by the examples in paragraphs 70 and 71, an enterprise's maximum potential loss from some recognised financial assets may differ significantly from their carrying amount and from other disclosed amounts such as their fair value or principal amount. In such circumstances, additional disclosure is necessary to meet the requirements of paragraph 66(a).

70. A financial asset subject to a legally enforceable right of set-off against a financial liability is not presented on the balance sheet net of the liability unless settlement is intended to take place on a net basis or simultaneously. Nevertheless, an enterprise discloses the existence of the legal right of set-off when providing information in accordance with paragraph 66. For example, when an enterprise is due to receive the proceeds from realisation of a financial asset before settlement of a financial liability of equal or greater amount against which the enterprise has a legal right of set-off, the enterprise has the ability to exercise that right of set-off to avoid incurring a loss in the event of a default by the counterparty. However, if the enterprise responds, or is likely to respond, to the default by extending the term of the financial asset, an exposure to credit risk would exist if the revised terms are such that collection of the proceeds is expected to be deferred beyond the date on which the liability is required to be settled. To inform financial statement users of the extent to which exposure to credit risk at a particular point in time has been reduced, the enterprise discloses the existence and effect of the right of set-off when the financial asset is expected to be collected in accordance

with its terms. When the financial liability against which a right of set-off exists is due to be settled before the financial asset, the enterprise is exposed to credit risk on the full carrying amount of the asset if the counterparty defaults after the liability has been settled.

71. An enterprise may have entered into one or more master netting arrangements that serve to mitigate its exposure to credit loss but do not meet the criteria for offsetting. When a master netting arrangement significantly reduces the credit risk associated with financial assets not offset against financial liabilities with the same counterparty, an enterprise provides additional information concerning the effect of the arrangement. Such disclosure indicates that:

    (a) the credit risk associated with financial assets subject to a master netting arrangement is eliminated only to the extent that financial liabilities due to the same counterparty will be settled after the assets are realised; and

    (b) the extent to which an enterprise's overall exposure to credit risk is reduced through a master netting arrangement may change substantially within a short period following the balance sheet date because the exposure is affected by each transaction subject to the arrangement.

    It is also desirable for an enterprise to disclose the terms of its master netting arrangements that determine the extent of the reduction in its credit risk.

72. When there is no credit risk associated with an unrecognised financial asset or the maximum exposure is equal to the principal, stated, face or other similar contractual amount of the instrument disclosed in accordance with paragraph 47 or the fair value disclosed in accordance with paragraph 77, no additional disclosure is required to comply with paragraph 66(a). However, with some unrecognised financial assets, the maximum loss that would be recognised upon default by the other party to the underlying instrument may differ substantially from the amounts disclosed in accordance with paragraphs 47 and 77. For example, an enterprise may have a right to mitigate the loss it would otherwise bear by setting off an unrecognised financial asset against an unrecognised financial liability. In such circumstances, paragraph 66(a) requires disclosure in addition to that provided in accordance with paragraphs 47 and 77.

73. Guaranteeing an obligation of another party exposes the guarantor to credit risk that would be taken into account in making the disclosures required by paragraph 66. This situation may arise as a result of, for example, a securitisation transaction in which an enterprise remains exposed to credit risk associated with financial assets that have been removed from its balance sheet. If the enterprise is obligated under recourse provisions of the transaction to indemnify the purchaser of the assets for credit losses, it discloses the nature of the assets removed from its balance sheet, the amount and timing of the future cash flows contractually due from the assets, the terms of the recourse obligation and the maximum loss that could arise under that obligation. (See also International Accounting Standard IAS 10, Contingencies and Events Occurring After the Balance Sheet Date).

74. Concentrations of credit risk are disclosed when they are not apparent from other disclosures about the nature and financial position of the business and they result in a significant exposure to loss in the event of default by other parties. Identification of significant concentrations is a matter for the exercise of judgement by management taking into account the circumstances of the enterprise and its debtors. International Accounting Standard IAS 14, Reporting Financial Information by Segment, provides useful guidance in identifying industry and geographic segments within which credit risk concentrations may arise.

75. Concentrations of credit risk may arise from exposures to a single debtor or to groups of debtors having a similar characteristic such that their ability to meet their obligations is expected to be affected similarly by changes in economic or other conditions. Characteristics that may give rise to a concentration of risk include the nature of the activities undertaken by debtors, such as the industry in which they operate, the geographic area in which activities are undertaken and the level of creditworthiness of groups of borrowers. For example, a manufacturer of equipment for the oil and gas industry will normally have trade accounts receivable from sale of its products for which the risk of non-payment is affected by economic changes in the oil and gas industry. A bank that normally lends on an international scale may have a significant amount of loans outstanding to less developed nations and the bank's ability to recover those loans may be adversely affected by local economic conditions.

76. Disclosure of concentrations of credit risk includes a description of the shared characteristic that identifies each concentration and the amount of the maximum credit risk exposure associated with all recognised and unrecognised financial assets sharing that characteristic.

Fair Value

77. ***For each class of financial asset and financial liability, both recognised and unrecognised, an enterprise should disclose information about fair value. When it is not practicable within constraints of timeliness or cost to determine the fair value of a financial asset or financial liability with sufficient reliability, that fact should be disclosed together with information about the principal characteristics of the underlying financial instrument that are pertinent to its fair value.***

78. Fair value information is widely used for business purposes in determining an enterprise's overall financial position and in making decisions about individual financial instruments. It is also relevant to many decisions made by users of financial statements since, in many circumstances, it reflects the judgement of the financial markets as to the present value of expected future cash flows relating to an instrument. Fair value information permits comparisons of financial instruments having substantially the same economic characteristics, regardless of their purpose and when and by whom they were issued or acquired. Fair values provide a neutral basis for assessing management's stewardship by indicating the effects of its decisions to buy, sell or hold financial assets and to incur, maintain or discharge financial liabilities. When an enterprise does not carry a financial asset or financial liability in its balance sheet at fair value, it provides fair value information through supplementary disclosures.

79. The fair value of a financial asset or financial liability may be determined by one of several generally accepted methods. Disclosure of fair value information includes disclosure of the method adopted and any significant assumptions made in its application.

80. Underlying the definition of fair value is a presumption that an enterprise is a going concern without any intention or need to liquidate, curtail materially the scale of its operations or undertake a transaction on adverse terms. Fair value is not, therefore, the amount that an enterprise would receive or pay in a forced transaction, involuntary liquidation or

distress sale. However, an enterprise takes its current circumstances into account in determining the fair values of its financial assets and financial liabilities. For example, the fair value of a financial asset that an enterprise has decided to sell for cash in the immediate future is determined by the amount that it expects to receive from such a sale. The amount of cash to be realised from an immediate sale will be affected by factors such as the current liquidity and depth of the market for the asset.

81. When a financial instrument is traded in an active and liquid market, its quoted market price, adjusted for the transaction costs that would be incurred in an actual transaction, provides the best evidence of fair value. The appropriate quoted market price for an asset held or liability to be issued is usually the current bid price and, for an asset to be acquired or liability held, the current offer or asking price. When current bid and offer prices are unavailable, the price of the most recent transaction may provide evidence of the current fair value provided that there has not been a significant change in economic circumstances between the transaction date and the reporting date. When an enterprise has matching asset and liability positions, it may appropriately use mid-market prices as a basis for establishing fair values.

82. When there is infrequent activity in a market, the market is not well established (for example, some "over the counter" markets) or small volumes are traded relative to the number of trading units of a financial instrument to be valued, quoted market prices may not be indicative of the fair value of the instrument. In these circumstances, as well as when a quoted market price is not available, estimation techniques may be used to determine fair value with sufficient reliability to satisfy the requirements of this Standard. Techniques that are well established in financial markets include reference to the current market value of another instrument that is substantially the same, discounted cash flow analysis and option pricing models. In applying discounted cash flow analysis, an enterprise uses a discount rate equal to the prevailing market rate of interest for financial instruments having substantially the same terms and characteristics, including the creditworthiness of the debtor, the remaining term over which the contractual interest rate is fixed, the remaining term to repayment of the principal and the currency in which payments are to be made.

83. The fair value to an enterprise of a financial asset or financial liability, whether determined from market value or otherwise, takes into account the costs that would be incurred to exchange or settle the underlying financial instrument. The costs may be relatively insignificant for instruments traded in organised, liquid markets but may be substantial for other instruments. Transaction costs may include taxes and duties, fees and commissions paid to agents, advisers, brokers or dealers and levies by regulatory agencies or securities exchanges.

84. When an instrument is not traded in an organised financial market, it may not be appropriate for an enterprise to determine and disclose a single amount that represents an estimate of fair value. Instead, it may be more useful to disclose a range of amounts within which the fair value of a financial instrument is reasonably believed to lie.

85. When disclosure of fair value information is omitted because it is not practicable to determine fair value with sufficient reliability, information is provided to assist users of the financial statements in making their own judgements about the extent of possible differences between the carrying amount of financial assets and financial liabilities and their fair value. In addition to an explanation of the reason for the omission and the principal characteristics of the financial instruments that are pertinent to their value, information is provided about the market for the instruments. In some cases, the terms and conditions of the instruments disclosed in accordance with paragraph 47 may provide sufficient information about the characteristics of the instrument. When it has a reasonable basis for doing so, management may indicate its opinion as to the relationship between fair value and the carrying amount of financial assets and financial liabilities for which it is unable to determine fair value.

86. The historical cost carrying amount of receivables and payables subject to normal trade credit terms usually approximates fair value. Similarly, the fair value of a deposit liability without a specified maturity is the amount payable on demand at the reporting date.

87. Fair value information relating to classes of financial assets or financial liabilities that are carried on the balance sheet at other than fair value is provided in a way that permits comparison between the carrying amount and the fair value. Accordingly, the fair values of recognised financial assets and financial liabilities are grouped into classes and offset only to the extent that their related carrying amounts are offset. Fair values of

unrecognised financial assets and financial liabilities are presented in a class or classes separate from recognised items and are offset only to the extent that they meet the offsetting criteria for recognised financial assets and financial liabilities.

Financial Assets Carried at an Amount in Excess of Fair Value

88. ***When an enterprise carries one or more financial assets at an amount in excess of their fair value, the enterprise should disclose:***

    (a) ***the carrying amount and the fair value of either the individual assets or appropriate groupings of those individual assets; and***

    (b) ***the reasons for not reducing the carrying amount, including the nature of the evidence that provides the basis for management's belief that the carrying amount will be recovered.***

89. Management exercises judgement in determining the amount it expects to recover from a financial asset and whether to write down the carrying amount of the asset when it is in excess of fair value. The information required by paragraph 88 provides users of financial statements with a basis for understanding management's exercise of judgement and assessing the possibility that circumstances may change and lead to a reduction in the asset's carrying amount in the future. When appropriate, the information required by paragraph 88(a) is grouped in a manner that reflects management's reasons for not reducing the carrying amount.

90. An enterprise's accounting policies with respect to recognition of declines in value of financial assets, disclosed in accordance with paragraph 47, assist in explaining why a particular financial asset is carried at an amount in excess of fair value. In addition, the enterprise provides the reasons and evidence specific to the asset that provide management with the basis for concluding that the asset's carrying amount will be recovered. For example, the fair value of a fixed rate loan intended to be held to maturity may have declined below its carrying amount as a result of an increase in interest rates. In such circumstances, the lender may not have reduced the carrying amount because there is no evidence to suggest that the borrower is likely to default.

Hedges of Anticipated Future Transactions

91. ***When an enterprise has accounted for a financial instrument as a hedge of risks associated with anticipated future transactions, it should disclose:***

    (a) ***a description of the anticipated transactions, including the period of time until they are expected to occur;***

    (b) ***a description of the hedging instruments; and***

    (c) ***the amount of any deferred or unrecognised gain or loss and the expected timing of recognition as income or expense.***

92. An enterprise's accounting policies indicate the circumstances in which a financial instrument is accounted for as a hedge and the nature of the special recognition and measurement treatment applied to the instrument. The information required by paragraph 91 permits the users of an enterprise's financial statements to understand the nature and effect of a hedge of an anticipated future transaction. The information may be provided on an aggregate basis when a hedged position comprises several anticipated transactions or has been hedged by several financial instruments.

93. The amount disclosed in accordance with paragraph 91(c) includes all accrued gains and losses on financial instruments designated as hedges of anticipated future transactions, without regard to whether those gains and losses have been recognised in the financial statements. The accrued gain or loss may be unrealised but recorded in the enterprise's balance sheet as a result of carrying the hedging instrument at fair value, it may be unrecognised if the hedging instrument is carried on the cost basis, or it may have been realised if the hedging instrument has been sold or settled. In each case, however, the accrued gain or loss on the hedging instrument has not been recognised in the enterprise's income statement pending completion of the hedged transaction.

Other Disclosures

94. Additional disclosures are encouraged when they are likely to enhance financial statement users' understanding of financial instruments. It may be desirable to disclose such information as:

(a) the total amount of the change in the fair value of financial assets and financial liabilities that has been recognised as income or expense for the period;

(b) the total amount of deferred or unrecognised gain or loss on hedging instruments other than those relating to hedges of anticipated future transactions; and

(c) the average aggregate carrying amount during the year of recognised financial assets and financial liabilities, the average aggregate principal, stated, notional or other similar amount during the year of unrecognised financial assets and financial liabilities and the average aggregate fair value during the year of all financial assets and financial liabilities, particularly when the amounts on hand at the balance sheet date are unrepresentative of amounts on hand during the year.

Transitional Provision

95. When comparative information for prior periods is not available when this International Accounting Standard is first adopted, such information need not be presented.

Effective Date

96. This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January, 1996.

Appendix

Examples of the Application of the Standard

The appendix is illustrative only and does not form part of the standards. The purpose of the appendix is to illustrate the application of the standards to assist in clarifying their meaning.

A1. This Appendix explains and illustrates the application of certain aspects of the Standard to various common financial instruments. The detailed examples are illustrative only and do not necessarily represent the only basis for applying the Standard in the specific circumstances discussed. Changing one or two of the facts assumed in the examples can lead to substantially different conclusions concerning the appropriate presentation or disclosure of a particular financial instrument. This Appendix does not discuss the application of all requirements of the Standard in the examples provided. In all cases, the provisions of the Standard prevail.

A2. The Standard does not deal with the recognition or measurement of financial instruments. Certain recognition and measurement practices may be assumed for purposes of illustration but they are not required.

Definitions

Common Types of Financial Instruments, Financial Assets and Financial Liabilities

A3. Currency (cash) is a financial asset because it represents the medium of exchange and is therefore the basis on which all transactions are measured and reported in financial statements. A deposit of cash with a bank or similar financial institution is a financial asset because it represents the contractual right of the depositor to obtain cash from the institution or to draw a cheque or similar instrument against the balance in favour of a creditor in payment of a financial liability.

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A4. Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

(a) trade accounts receivable and payable;

(b) notes receivable and payable;

(c) loans receivable and payable; and

(d) bonds receivable and payable.

In each case, one party's contractual right to receive (or obligation to pay) cash is matched by the other party's corresponding obligation to pay (or right to receive).

A5. Another type of financial instrument is one for which the economic benefit to be received or given up is a financial asset other than cash. For example, a note payable in government bonds gives the holder the contractual right to receive and the issuer the contractual obligation to deliver government bonds, not cash. The bonds are financial assets because they represent obligations of the issuing government to pay cash. The note is, therefore, a financial asset of the note holder and a financial liability of the note issuer.

A6. Under International Accounting Standard IAS 17, Accounting for Leases, a finance lease is accounted for as a sale with delayed payment terms. The lease contract is considered to be primarily an entitlement of the lessor to receive, and an obligation of the lessee to pay, a stream of payments that are substantially the same as blended payments of principal and interest under a loan agreement. The lessor accounts for its investment in the amount receivable under the lease contract rather than the leased asset itself. An operating lease, on the other hand, is considered to be primarily an uncompleted contract committing the lessor to provide the use of an asset in future periods in exchange for consideration similar to a fee for a service. The lessor continues to account for the leased asset itself rather than any amount receivable in the future under the contract. Accordingly, a finance lease is considered to be a financial instrument and an operating lease is considered not to be a financial instrument (except as regards individual payments currently due and payable).

Equity Instruments

A7. Examples of equity instruments include common shares, certain types of preferred shares, and warrants or options to subscribe for or purchase common shares in the issuing enterprise. An enterprise's obligation to issue its own equity instruments in exchange for financial assets of another party is not potentially unfavourable since it results in an increase in equity and cannot result in a loss to the enterprise. The possibility that existing holders of an equity interest in the enterprise may find the fair value of their interest reduced as a result of the obligation does not make the obligation unfavourable to the enterprise itself.

A8. An option or other similar instrument acquired by an enterprise that gives it the right to reacquire its own equity instruments is not a financial asset of the enterprise. The enterprise will not receive cash or any other financial asset through exercise of the option. Exercise of the option is not potentially favourable to the enterprise since it results in a reduction in equity and an outflow of assets. Any change in equity recorded by the enterprise from reacquiring and cancelling its own equity instruments represents a transfer between those holders of equity instruments who have given up their equity interest and those who continue to hold an equity interest, rather than a gain or loss by the enterprise.

Derivative Financial Instruments

A9. On inception, derivative financial instruments give one party a contractual right to exchange financial assets with another party under conditions that are potentially favourable, or a contractual obligation to exchange financial assets with another party under conditions that are potentially unfavourable. Some instruments embody both a right and an obligation to make an exchange. Since the terms of the exchange are determined on inception of the derivative instrument, as prices in financial markets change, those terms may become either favourable or unfavourable.

A10. A put or call option to exchange financial instruments gives the holder a right to obtain potential future economic benefits associated with changes in the fair value of the financial instrument underlying the contract. Conversely, the writer of an option assumes an obligation to forego potential future economic benefits or bear potential losses of economic benefits associated with changes in the fair value of the underlying financial instrument. The contractual right of the holder and obligation of the writer meet the definition of a financial asset and a financial liability respectively. The financial instrument underlying an option contract may be any financial asset, including shares and interest-bearing instruments. An option may require the writer to issue a debt instrument, rather than transfer a financial asset, but the instrument underlying the option would still constitute a financial asset of the holder if the option were exercised. The option-holder's right to exchange the assets under potentially favourable conditions and the writer's obligation to exchange the assets under potentially unfavourable conditions are distinct from the underlying assets to be exchanged upon exercise of the option. The nature of the holder's right and the writer's obligation is not affected by the likelihood that the option will be exercised. An option to buy or sell an asset other than a financial asset (such as a commodity) does not give rise to a financial asset or financial liability because it does not fit the requirements of the definitions for the receipt or delivery of financial assets or exchange of financial instruments.

A11. Another example of a derivative financial instrument is a forward contract to be settled in six months' time in which one party (the purchaser) promises to deliver 1,000,000 cash in exchange for 1,000,000 face amount of fixed rate government bonds, and the other party (the seller) promises to deliver 1,000,000 face amount of fixed rate government bonds in exchange for 1,000,000 cash. During the six months, both parties have a contractual right and a contractual obligation to exchange financial instruments. If the market price of the government bonds rises above 1,000,000, the conditions will be favourable to the purchaser and unfavourable to the seller; if the market price falls below 1,000,000, the effect will be the opposite. The purchaser has both a contractual right (a financial asset) similar to the right under a call option held and a contractual obligation (a financial liability) similar to the obligation under a put option written; the seller has a contractual right (a financial asset) similar to the right under a put option held and a contractual obligation (a financial liability) similar to the obligation under a call option written. As with options, these contractual rights and obligations constitute financial assets and financial liabilities separate and distinct from the underlying financial instruments (the bonds and cash to be exchanged). The significant difference between a forward contract and an option contract is that both parties to a forward contract have an obligation to perform at the agreed time, whereas performance under an option contract occurs only if and when the holder of the option chooses to exercise it.

A12. Many other types of derivative instruments embody a right or obligation to make a future exchange, including interest rate and currency swaps, interest rate caps, collars and floors, loan commitments, note issuance facilities and letters of credit. An interest rate swap contract may be viewed as a variation of a forward contract in which the parties agree to make a series of future exchanges of cash amounts, one amount calculated with reference to a floating interest rate and the other with reference to a fixed interest rate. Futures contracts are another variation of forward contracts, differing primarily in that the contracts are standardised and traded on an exchange.

Commodity Contracts and Commodity-linked Financial Instruments

A13. As indicated by paragraph 14 of the Standard, contracts that provide for settlement by receipt or delivery of a physical asset only (for example, an option, futures or forward contract on silver) are not financial instruments. Many commodity contracts are of this type. Some are standardised in form and traded on organised markets in much the same fashion as some derivative financial instruments. For example, a commodity futures contract may be readily bought and sold for cash because it is listed for trading on an exchange and may change hands many times. However, the parties buying and selling the contract are, in effect, trading the underlying commodity. The ability to buy or sell a commodity contract for cash, the ease with which it may be bought or sold and the possibility of negotiating a cash settlement of the obligation to receive or deliver the commodity do not alter the fundamental character of the contract in a way that creates a financial instrument.

A14. A contract that involves receipt or delivery of physical assets does not give rise to a financial asset of one party and a financial liability of the other party unless any corresponding payment is deferred past the date on which the physical assets are transferred. Such is the case with the purchase or sale of goods on trade credit.

A15. Some contracts are commodity-linked but do not involve settlement through physical receipt or delivery of a commodity. They specify settlement through cash payments that are determined according to a formula in the contract, rather than through payment of fixed amounts.

For example, the principal amount of a bond may be calculated by applying the market price of oil prevailing at the maturity of the bond to a fixed quantity of oil. The principal is indexed by reference to a commodity price but is settled only in cash. Such a contract constitutes a financial instrument.

A16. The definition of a financial instrument encompasses also a contract that gives rise to a non-financial asset or liability in addition to a financial asset or liability. Such financial instruments often give one party an option to exchange a financial asset for a non-financial asset. For example, an oil-linked bond may give the holder the right to receive a stream of fixed periodic interest payments and a fixed amount of cash on maturity, with the option to exchange the principal amount for a fixed quantity of oil. The desirability of exercising this option will vary from time to time based on the fair value of oil relative to the exchange ratio of cash for oil (the exchange price) inherent in the bond. The intentions of the bondholder concerning the exercise of the option do not affect the substance of the component assets. The financial asset of the holder and the financial liability of the issuer make the bond a financial instrument, regardless of the other types of assets and liabilities also created.

A17. Although the Standard was not developed to apply to commodity or other contracts that do not satisfy the definition of a financial instrument, enterprises may consider whether it is appropriate to apply the relevant portions of the disclosure standards to such contracts.

Liabilities and Equity

A18. It is relatively easy for issuers to classify certain types of financial instruments as liabilities or equity. Examples of equity instruments include common (ordinary) shares and options that, if exercised, would require the writer of the option to issue common shares. Common shares do not oblige the issuer to transfer assets to shareholders, except when the issuer formally acts to make a distribution and becomes legally obligated to the shareholders to do so. This may be the case following declaration of a dividend or when the enterprise is being wound up and any assets remaining after the satisfaction of liabilities become distributable to shareholders.

"Perpetual" debt instruments

A19. "Perpetual" debt instruments, such as "perpetual" bonds, debentures and capital notes, normally provide the holder with the contractual right to receive payments on account of interest at fixed dates extending into the indefinite future, either with no right to receive a return of principal or a right to a return of principal under terms that make it very unlikely or very far in the future. For example, an enterprise may issue a financial instrument requiring it to make annual payments in perpetuity equal to a stated interest rate of 8% applied to a stated par or principal amount of 1,000. Assuming 8% to be the market rate of interest for the instrument when issued, the issuer assumes a contractual obligation to make a stream of future interest payments having a fair value (present value) of 1,000. The holder and issuer of the instrument have a financial asset and financial liability, respectively, of 1,000 and corresponding interest income and expense of 80 each year in perpetuity.

Preferred Shares

A20. Preferred (or preference) shares may be issued with various rights. In classifying a preferred share as a liability or equity, an enterprise assesses the particular rights attaching to the share to determine whether it exhibits the fundamental characteristic of a financial liability. For example, a preferred share that provides for redemption on a specific date or at the option of the holder meets the definition of a financial liability if the issuer has an obligation to transfer financial assets to the holder of the share. The inability of an issuer to satisfy an obligation to redeem a preferred share when contractually required to do so, whether due to a lack of funds or a statutory restriction, does not negate the obligation. An option of the issuer to redeem the shares does not satisfy the definition of a financial liability because the issuer does not have a present obligation to transfer financial assets to the shareholders. Redemption of the shares is solely at the discretion of the issuer. An obligation may arise, however, when the issuer of the shares exercises its option, usually by formally notifying the shareholders of an intention to redeem the shares.

A21. When preferred shares are non-redeemable, the appropriate classification is determined by the other rights that may attach to them. When distributions to holders of the preferred shares whether. cumulative or non-cumulative, are at the discretion of the issuer, the shares are equity instruments.

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Compound Financial Instruments

A22. Paragraph 23 of the Standard applies only to a limited group of compound instruments for the purpose of having the issuers present liability and equity components separately on their balance sheets. Paragraph 23 does not deal with compound instruments from the perspective of holders.

A23. A common form of compound financial instrument is a debt security with an embedded conversion option, such as a bond convertible into common shares of the issuer. Paragraph 23 of the Standard requires the issuer of such a financial instrument to present the liability component and the equity component separately on the balance sheet from their initial recognition.

(a) The issuer's obligation to make scheduled payments of interest and principal constitutes a financial liability which exists as long as the instrument is not converted. On inception, the fair value of the liability component is the present value of the contractually determined stream of future cash flows discounted at the rate of interest applied by the market at that time to instruments of comparable credit status and providing substantially the same cash flows, on the same terms, but without the conversion option.

(b) The equity instrument is an embedded option to convert the liability into equity of the issuer. The fair value of the option comprises its time value and its intrinsic value, if any. The intrinsic value of an option or other derivative financial instrument is the excess, if any, of the fair value of the underlying financial instrument over the contractual price at which the underlying instrument is to be acquired, issued, sold or exchanged. The time value of a derivative instrument is its fair value less its intrinsic value. The time value is associated with the length of the remaining term to maturity or expiry of the derivative instrument. It reflects the income foregone by the holder of the derivative instrument from not holding the underlying instrument, the cost avoided by the holder of the derivative instrument from not having to finance the underlying instrument and the value placed on the probability that the intrinsic value of the derivative instrument will increase prior to its maturity or expiry due to future volatility in the fair value of the underlying instrument. It is uncommon for the embedded option in a convertible bond or similar instrument to have any intrinsic value on issuance.

A24. Paragraph 28 of the Standard describes how the components of a compound financial instrument may be valued on initial recognition. The following example illustrates in greater detail how such valuations may be made.

An enterprise issues 2,000 convertible bonds at the start of Year 1. The bonds have a three year term, and are issued at par with a face value of 1,000 per bond, giving total proceeds of 2,000,000. Interest is payable annually in arrears at a nominal annual interest rate of 6%. Each bond is convertible at any time up to maturity into 250 common shares.

When the bonds are issued, the prevailing market interest rate for similar debt without conversion options is 9%. At the issue date, the market price of one common share is 3. The dividends expected over the three year term of the bonds amount to 0.14 per share at the end of each year. The risk-free annual interest rate for a three year term is 5%.

Residual valuation of equity component

Under this approach, the liability component is valued first, and the difference between the proceeds of the bond issue and the fair value of the liability is assigned to the equity component. The present value of the liability component is calculated using a discount rate of 9%, the market interest rate for similar bonds having no conversion rights, as shown.

Present value of the principal – 2,000,000 payable at the end of three years	1,544,367
Present value of the interest – 120,000 payable annually in arrears for three years	303,755
Total liability component	1,848,122
Equity component (by deduction)	151,878
Proceeds of the bond issue	2,000,000

3. The present value of the expected dividends over the term of the option is deducted from the market price, since the payment of dividends reduces the fair value of the shares and thus the fair value of the option. The present value of a dividend of 0.14 per share at the end of each year, discounted at the risk-free rate of 5%, is 0.3813. The present value of the asset underlying the option is therefore:

$$3 - 0.3813 = 2.6187 \text{ per share}$$

The present value of the exercise price is 4 per share discounted at the risk-free rate of 5% over three years, assuming that the bonds are converted at maturity, or 3.4554. The ratio is thus determined as:

$$2.6187 \div 3.4554 = \underline{\underline{0.7579}}$$

The bond conversion option is a form of call option. The call option valuation table indicates that, for the two amounts calculated above (i.e. 0.5196 and 0.7579), the fair value of the option is approximately 11.05% of the fair value of the underlying asset.

The valuation of the conversion options can therefore be calculated as:

$$0.1105 \times 2.6187 \text{ per share} \times 250 \text{ shares per bond} \times 2{,}000 \text{ bonds} = \underline{144{,}683}$$

The fair value of the debt component of the compound instrument calculated above by the present value method plus the fair value of the option calculated by the Black–Scholes option pricing model does not equal the 2,000,000 proceeds from issuance of the convertible bonds (i.e. 1,848,122 + 144,683 = 1,992,805). The small difference can be prorated over the fair values of the two components to produce a fair value for the liability of 1,854,794 and a fair value for the option of 145,206.

Offsetting of a Financial Asset and a Financial Liability

A25. The Standard does not provide special treatment for so–called "synthetic instruments", which are groupings of separate financial instruments acquired and held to emulate the characteristics of another instrument. For example, a floating rate long term debt combined with an interest rate swap that involves receiving floating payments and making fixed payments synthesises a fixed rate long term debt. Each of the separate components of a "synthetic instrument" represents a contractual right or obligation with its own terms and conditions and each may be transferred or settled separately. Each component is exposed to risks that may differ from the risks to which other components are exposed. Accordingly, when one component of a "synthetic instrument" is an asset and another is a liability, they are not offset and presented on an enterprise's balance sheet on a net basis unless they meet the criteria for offsetting in paragraph 33 of the Standard. Such is often not the case. Disclosures are provided about the significant terms and conditions of each financial instrument constituting a component of a "synthetic instrument" without regard to the existence of the "synthetic instrument", although an enterprise may indicate in addition the nature of the relationship between the components (see paragraph 51 of the Standard).

Disclosure

A26. Paragraph 53 of the Standard lists examples of broad categories of matters that, when significant, an enterprise addresses in its disclosure of accounting policies. In each case, an enterprise has a choice from among two or more different accounting treatments. The following discussion elaborates on the examples in paragraph 53 and provides further examples of circumstances in which an enterprise discloses its accounting policies.

(a) An enterprise may acquire or issue a financial instrument under which the obligations of each party are partially or completely unperformed (sometimes referred to as an unexecuted or executory contract). Such a financial instrument may involve a future exchange and performance may be conditional on a future event. For example, neither the right nor the obligation to make an exchange under a forward contract results in any transaction in the underlying financial instrument until the maturity of the contract but the right and obligation constitute a financial asset and a financial liability, respectively. Similarly, a financial guarantee does not require the guarantor to assume any obligation to the holder of the guaranteed debt until an event of default has occurred. The guarantee is, however, a financial liability of the guarantor because it is a contractual obligation to exchange one financial instrument (usually cash) for another (a receivable from the defaulted debtor) under conditions that are potentially unfavourable.

(b) An enterprise may undertake a transaction that, in form, constitutes a direct acquisition or disposition of a financial instrument but does not involve the transfer of the economic interest in it. Such is the case with some types of repurchase and reverse repurchase agreements. Conversely, an enterprise may acquire or transfer to another party an economic interest in a financial instrument through a transaction that, in form, does not involve an acquisition or disposition of legal title. For example, in a non-recourse borrowing, an enterprise may pledge accounts receivable as collateral and agree to use receipts from the pledged accounts solely to service the loan.

(c) An enterprise may undertake a partial or incomplete transfer of a financial asset. For example, in a securitisation, an enterprise acquires or transfers to another party some, but not all, of the future economic benefits associated with a financial instrument.

(d) An enterprise may be required, or intend, to link two or more individual financial instruments to provide specific assets to satisfy specific obligations. Such arrangements include, for example, "in substance" defeasance trusts in which financial assets are set aside for the purpose of discharging an obligation without those assets having been accepted by the creditor in settlement of the obligation, non-recourse secured financing and sinking fund arrangements.

(e) An enterprise may use various risk management techniques to minimise exposures to financial risks. Such techniques include, for example, hedging, interest rate conversion from floating rate to fixed rate or fixed rate to floating rate, risk diversification, risk pooling, guarantees and various types of insurance (including sureties and "hold harmless" agreements). These techniques generally reduce the exposure to loss from only one of several different financial risks associated with a financial instrument and involve the assumption of additional but only partially offsetting risk exposures.

(f) An enterprise may link two or more separate financial instruments together notionally in a "synthetic" instrument or for some purposes other than those described in items (d) and (e) above.

(g) An enterprise may acquire or issue a financial instrument in a transaction in which the amount of the consideration exchanged for the instrument is uncertain. Such transactions may involve non-cash consideration or an exchange of several items.

(h) An enterprise may acquire or issue a bond, promissory note or other monetary instrument with a stated amount or rate of interest that differs from the prevailing market interest rate applicable to the instrument. Such financial instruments include zero coupon bonds and loans made on apparently favourable terms but involving non-cash consideration, for example, low interest rate loans to employees.

A27. Paragraph 54 of the Standard lists several issues that an enterprise addresses in its disclosure of accounting policies when the issues are significant to the application of the cost basis of measurement. In the case of uncertainty about the collectibility of amounts realisable from a monetary financial asset or a decline in the fair value of a financial asset below its carrying amount due to other causes, an enterprise indicates its policies for determining:

(a) when to reduce the carrying amount of the asset;

(b) the amount to which it reduces the carrying amount;

(c) how to recognise any income from the asset; and

(d) whether the reduction in carrying amount may be reversed in the future if circumstances change.