

## **Prerequisites of banking supervision based on 25 Basel's core principles for effective banking supervision**

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The Basel Core Principles define 25 principles that are needed for a supervisory system to be effective. Those principles are broadly categorised into seven groups: Objectives, independence, powers, transparency and cooperation (principle 1); Licensing and structure (principles 2 to 5); Prudential regulation and requirements (principles 6 to 18); Methods of ongoing banking supervision (principles 19 to 21); Accounting and disclosure (principle 22); Corrective and remedial powers of supervisors (principle 23); Consolidated and cross-border banking supervision (principles 24 and 25). The principles are:

***Principle 1 – Objectives, independence, powers, transparency and cooperation:*** An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the discharge of its duties. 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.

***Principle 2 – Permissible activities:*** 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 – Licensing criteria:*** The licensing authority must have the power 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 ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, 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.

***Principle 4 – Transfer of significant ownership:*** The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

***Principle 5 – Major acquisitions:*** The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

***Principle 6 – Capital adequacy:*** Supervisors must set prudent and appropriate minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.

***Principle 7 – Risk management process:*** Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

***Principle 8 – Credit risk:*** Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.

***Principle 9 – Problem assets, provisions and reserves:*** Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.

***Principle 10 – Large exposure limits:*** Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.

***Principle 11 – Exposures to related parties:*** In order to prevent abuses arising from exposures (both on balance sheet and off balance sheet) to related parties and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

***Principle 12 – Country and transfer risks:*** Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

***Principle 13 – Market risks:*** Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

***Principle 14 – Liquidity risk:*** Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk,

and to manage liquidity on a day-to-day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

***Principle 15 – Operational risk:*** Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and control/mitigate operational risk. These policies and processes should be commensurate with the size and complexity of the bank.

***Principle 16 – Interest rate risk in the banking book:*** Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to the size and complexity of such risk.

***Principle 17 – Internal control and audit:*** Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity 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 the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

***Principle 18 – Abuse of financial services:*** Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

***Principle 19 – Supervisory approach:*** An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

***Principle 20 – Supervisory techniques:*** An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

***Principle 21 – Supervisory reporting:*** Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.

***Principle 22 – Accounting and disclosure:*** Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

***Principle 23 – Corrective and remedial powers of supervisors:*** Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking license or to recommend its revocation.

***Principle 24 – Consolidated supervision:*** An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately

monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.

***Principle 25 – Home-host relationships:*** Cross-border consolidated supervision requires cooperation and information exchange between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards as those required of domestic institutions.

On the basis of the 25 core principles defined by the Basel Committee for the effective supervision of banks' operation, prerequisites of the supervision of Central banks on Commercial banks are formulated, including:

***A. Legal regulations on the supervision of Central banks on Commercial banks***

*For Central banks*

In accordance with the principle 1 to principle 5, for the effective supervision of Central banks on Commercial banks, regulations should be defined clearly and closely on the competence, duties and roles of the Central bank in the supervision on the Commercial bank. Specifically:

- Responsibilities of the Central bank and other relevant supervisors in supervising the Commercial bank should be defined systematically, feasibly and clearly by law. The Central bank should possess operational independence in order not to bear financial pressures and be able to implement its objectives.

- Law on banking should also define minimum standards that must be satisfied by banks; enabling the Central bank to regulate guarantee norms flexibly in the manner of financial compulsion, where necessary, in order to achieve outlined objectives as well as use qualitative assessment; authorizing the information collection and confirmation independently to the Central bank; and authorizing the Central bank to fine one of certain violations when guarantee norms are not observed (including right to reject individuals from banking activities, implement banned orders or revoke licenses).

- Supervision of the Central bank should be protected in conformity its competence from hindrances of organizations and individuals in the process of supervision.

- A cooperation system between the Central bank and relevant supervisors should be established to share appropriate information among official authorities, both internally and externally, take responsibility for the security and healthiness of the financial system; this cooperation should be supported by protecting the confidentiality of the supervisory information and ensuring that this information is only used for the purpose relating to supervising effectively relevant authorities.

*For the Commercial bank*

- The number of credit authorities or commercial banks subject to the supervision of the Central bank should be accurately specified. The phrase “Commercial bank” should be clearly defined and regulated the granting of operational licenses and scope for commercial banks. For example, the receipt of deposits from the public is only permitted in commercial banks licensed and under the supervision of the Central bank.

- Commercial banks must possess a license of the Central bank to operate, accordingly, under the supervision of the Central bank when they want to withdraw or participate in the system of commercial banks. Commercial banks that are newly established should be put under the supervision of the Central bank in terms of shareholders lists, financial capacity, legal mechanism and the capacity of management staff. If commercial banks do not fully meet requirements of the Central bank on the assessment of the possessive structure of the banks, members of the management board and the director board, operation plan and internal monitoring, they may be rejected to grant operational licenses by the Central bank.

***B. Consistent criteria in the supervisory content and organization***

*Formulation of consistent supervisory content*

Types of commercial banks supervised by the Central bank have to be at risk in the banking operation. Therefore, an important part in the supervision of banking operation is that the Central bank has rights to formulate and apply regulations and requirements on guarantees to control the risks. The Central bank can specify minimum criteria on guarantees to ensure the proper operation of banks. The flexibility of banking operation requires the Central bank to evaluate periodically its guarantee requirements and evaluate the appropriateness of current requirements as well as the need to issue new requirements.

The supervision should be executed in accordance with consistent contents for commercial banks, including:

- *Evaluation of the capital adequacy*

According to principle 6 of the Basel Committee, the Central bank must set prudent and appropriate minimum capital adequacy requirements and encourage banks to possess more than the minimum capital. The Central bank should also consider the requirement on the capital higher than the minimum rate when necessary if the specific risk rate of a bank is more or there are uncertain factors related to the quality of the property, the risk concentration rate and other adverse characteristics of the banks' financial situation. If the bank's capital rate is lower than the minimum rate, the Central bank should ensure that the bank has a feasible plan to achieve the minimum rate properly. The Central bank should also consider whether it must apply more restrictions in that case or not.

*- Evaluation of the credit risk management*

Principles 7, 8, 9, 10 defined by Basel Committee for the purpose of instructing supervisors to formulate detailed contents for the evaluation of a commercial bank's credit risk management, including:

Evaluation of criteria at credit level and the process of credit consideration of commercial banks (defined in Principle 7).

Evaluation of the quality of the assets and the adequacy of provisions and reserves for risks. (defined in Principle 8).

Evaluation of commercial banks' risk concentration of (defined in Principle 9).

Evaluation of the equity in granting credits to customers (defined in Principle 9).

*- Evaluation of the market risk management*

In line with Principle 12, the Central bank must define if banks measure accurately and control properly the market risks. Where applicable, it is appropriate to publicize a restriction on the price risks that banks have to face with, especially the risks resulting from banks' business operation.

*- Evaluation of the interest rate risk management*

The Central bank should monitor the way banks control the interest rate risks including the supervision of the management board and board of directors, policies and procedures of risk management, measurement and risk monitoring systems and overall control measures. In addition, supervisors should fully and timely collect information from banks in order to evaluate the interest rate risks. The information should include terms and currencies in the investment catalogue of each bank as well as other relevant factors such as the discrimination between business operation and non-business operation.

*- Evaluation of liquidity risk management*

The liquidity risk management is for the purpose of ensuring banks' full commitment performance. Of the important factors of the liquidity management are the good management information system, the central liquidity control, analysis of requirements on granting net capital in various situations, diversification of capital sources and reserve plan outlining. The Central bank should require banks to manage their available assets, liabilities and foreign exchange contracts with view to maintain the liquidity. Banks should also have various capital-granting sources, even capital sources and terms. They should also maintain the property with high liquidity.

*- Evaluation of operational risk management*

The Central bank should ensure that the board of directors of banks apply effective auditing procedures and internal control measures; at the same time ensure that banks have management policies and reduce the operational risks (for example, through insurance or outlining reserve plans). The Central banks should define that banks with plans on recovering their operation are fully verified all main systems with offsite supporting facilities to protect banks from unprecedented events.

- *Evaluation of other risk management*

Such risks as country and transfer risks defined in Principles 11 and 13. Accordingly, the Central bank must ensure that banks have all policies and procedures on determining, monitoring and controlling the country and transfer risks in their investment activities and international lending, and for maintaining adequate provisions and reserves amount against such risks. Besides, the Central bank must ensure that banks have a comprehensive risk management process (including the supervision of the board of directors and the management board) to determine, measure, monitor and control all other existing risks and have enough capital to cope with these risks where appropriate.

- *Evaluation of the internal control system*

This content is mentioned in the two principles 14 and 15. Thereof, the internal control is to ensure that banks are operated prudently in conformity with the policies and strategies outlined by the management board; transactions are executed in conformity with their competence; assets are guaranteed, liabilities are in control; accounting documents and others supply full, proper and accurate information; and managing officers can determine, evaluate, manage and control the risks of business operation.

*Consent of the monitoring structure*

The words of principle 16 to principle 20 stipulate that the collection and analysis of information are needed for the monitoring, which can be implemented onsite and offsite. An effective monitoring system shall employ both forms.

Normally, the Central bank supervises commercial banks via two main parts, namely offsite surveillance and onsite inspection. The Central bank's supervision must put the two parts in close cooperation.

- **Offsite surveillance: Supervising the operation of commercial banks regularly through data systemization and analysis of commercial banks' operation according to financial reports and data supplied by commercial banks, accordingly, establishing an early warning system for specific commercial banks and for the whole commercial bank system.**

- **Onsite inspection: According to the information from the offsite surveillance, the Central banks should make plans on periodic or unexpected inspection for commercial banks in order to rank commercial banks and warn commercial banks of risks in their operation. Onsite inspectors shall examine inquiry matters, assess and make decisions and requirements on operation and development for troublesome commercial banks.**

The Central bank's ability to perform its consolidated supervision on banks is an important part of the supervision, including the ability to consider both banking activities and non-banking activities implemented directly or indirectly (via subsidiary companies and companies directly under the banks), and activities in the local and foreign offices. The Central bank should take into account banks' non-financial activities that may cause risks. The Central bank should also decide to apply which guarantee requirements on the solo basis and on the consolidated basis and both. Under all circumstances, the Central banks must be aware of the general structure of banks or banking corporation when supervision methods are employed. The Central bank should also cooperate with other competent authorities in supervising specific entities in the scope of the banks' structure.

### **C. Requirements on information in supervising commercial banks**

*Principle 21.* Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

For the effective offsite surveillance on banks and assessment on conditions of the domestic banking market, supervisors must regularly obtain financial information that is verified periodically through external auditing. Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability. In order for the fair reflection of accounts, it is important to evaluate assets at the current and consistent value, reckoning the current value where applicable and the net profits may be obtained and reckoning the accounts that may be transferred to reserves and provisions. It is important that banks supply information in the way of comparison among banks and with regards to some specific purposes, information collected from the internal management information system can also be useful for supervisors. At least, periodic reports should include the balance sheet of banks' assets, uncertain liabilities, turnover accounting with details on major risks.

If banks willfully or accidentally supply incorrect information in the supervision process, supervisors can deviate. If a bank supplies supervisors with incorrect information willfully or

accidentally, supervisory and criminal measures shall be applied for relevant individuals and the whole bank.

#### *Accounting standards*

In order to ensure the correct and clear information supplied by banks, supervisors shall define clearly accounting standards in making reports in accordance with accounting principles and rules widely accepted internationally and aimed specifically at banks.

#### *Reporting scope and frequency*

Supervisors should have a right to define the reporting scope and frequency in compliance with the fluctuations of the business operation and be allowed to supervise the ongoing in each bank on both solo and consolidated basis, as well as in the whole banking system. Supervisors should formulate a number of report forms for banks to prepare and supply periodically. While some reports can be submitted monthly, some others can be submitted quarterly or annually. In addition, there are sometimes “unexpected reports” which are made when a special event happens (for example, investment in a subsidiary company). Supervisors should be sensitively aware of burdens resulting from reports. Therefore, they can define that it is not necessary to require all banks to submit reports. The submission of reports should be based on banks’ organizational structures, scales and operational types.

#### *Confirmation of the accuracy of the information obtained*

Managing officials of banks are responsible for the accuracy, adequacy and properness of guarantee reports, financial reports and others submitted to supervisors. Thus, managing officials of banks must be satisfied that reports are verified and external auditing agencies certify that the bank’s reporting system is adequate and the information is reliable. External auditing agencies should express their opinions on annual reports and managing reports publicized for shareholders of the bank and for the public. Due to shortcomings in the banking auditing standards in some countries, supervisors may be required to involve in giving clear guides on the scope and content of auditing programs as well as auditing standards that have been used. In the worst case that supervisors cannot be satisfied with the quality of annual reports or assessment reports or the external auditing, they should have ability to employ supervisory measures to timely address, and they can maintain their right to permit reports to be publicized.

In the evaluation of the quality and satisfaction of the work performed by the auditing agencies and the reliability in that work, supervisors shall consider the evaluation of auditing programs in the aspects of banks’ loans, risk provisions and reserves, bad quality assets (including the settlement of the assets’ interest rate), evaluation of assets, business activities, securitization of assets and the adequacy of the internal control on the financial reporting

mechanism. When internal auditing is adequately competent and separated from the management part, it may be employed as a source of information and it may help supervisors understand more about banking field.

*The confidentiality of the supervisory information*

Though market members should have access to accurate and proper information, some sensitive information of group 27 should be kept confidential by banking supervisors. In order to establish a reliable relationship with each other, banks should know that this sensitive information shall be kept secret by supervisors as well as their local and foreign partners.

*Information publicization*

In order for the market to operate effectively, accordingly, to enhance the stability and efficiency of the financial system, members of the market should have access to accurate information timely. Therefore, information publicization is a complementary function of supervision. With this reason, banks must fully and honestly publicize information relating to their operation and financial situation . This information should be supplied fully and timely to members of the market in order to assess the rate of risks of banks.

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