EU-RUSSIA COOPERATION PROGRAMME

BANKING SUPERVISION

EUROPEAN EXPERIENCE AND RUSSIAN PRACTICE

A BOOK PREPARED AS A PART OF THE PROJECT

– Central Bank Training III –

Editor: Michael Olsen

This project is funded by the European Union

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FOREWORDS

FOREWORD

Although it remains largely a mystery to the general public, banking supervision plays a key role in the world economy and for the economic development of each country. It has implications on all our lives.

In Russia, banking reform – and in particular the reform of banking supervision – is crucial for economic diversification and sustainable long-term growth. Over the last years the Bank of Russia has therefore embarked upon thoroughgoing reform of the banking sector.

The EU also is actively modernising its financial sector – the introduction of the New Capital Accord illustrates the importance of the reform of supervision for the EU economy. All over the world, banking reform developments outline a movement of international convergence. The reform of a country's banking sector thus also appears crucial for its successful integration into the world economy.

This book on banking supervision brings together the expertise of both the European central banks and supervision authorities and the Bank of Russia – and this makes it unique. But it is also a reflection of EU-Russian efforts to maintain the momentum of reform in the context of globalisation of the financial markets.

It is therefore a particular pleasure for me to associate the European Commission with the publication of the book on banking supervision – as a sign of the EU's commitment to support an effective and independent supervision in accordance with the highest international standards and norms in the perspective of a Common Economic Space between the EU and Russia.

H. E. Marc Franco
Ambassador, Head of Delegation of the European Commission to Russia

FOREWORD

The publication of this book was made possible thanks to the enthusiasm and efforts of the many experts from all over the European Union, who are not only united by common professional interests but also by a sincere desire to enhance mutual cooperation.

In the framework of the 2003-2005 Tacis project, experts from the European Central Bank, the central banks of the Eurosystem and EU countries' supervision authorities held direct and open dialogues with their colleagues from the Bank of Russia, generously sharing their knowledge and experience in one of the most complex areas of banking, namely banking supervision.

In the context of market-oriented transformations within the Russian economy, the banking sector is developing in a particularly dynamic fashion. The Bank of Russia has been creating its system of banking supervision based mainly on approaches promoted by the international banking community. However, the specialised knowledge and practical skills acquired by Russian experts over the years of reform in the country appear to have been insufficient in order to move forward along the road leading to modern, qualitative and risk-focused banking supervision. The results of this project, which still need to be appropriately assimilated by Russian experts, are intended to fill a large part of this gap. This book, which is a unique result of the above-mentioned cooperation, will serve more than one generation of Russian banking experts. I also hope that, in turn, the foreign reader will obtain an idea of how banking supervision is organised in Russia.

The successful implementation of such a large-scale project would not have been possible without the dedicated work of colleagues from the Delegation of the European Commission to Russia, the European Central Bank and its partners who were involved. All of them deserve our sincere and deep gratitude.

I firmly believe that the results of this project, as well as the close working relationships and warm personal bonds that have been formed during its period of implementation, reflect the huge potential for future cooperation between the Bank of Russia and the Eurosystem within the context of technical assistance.

Sergey Ignatiev
Chairman of the Central Bank of the Russian Federation

FOREWORD

The TACIS project was a new activity for the European Central Bank and its 12 partner institutions, nine central banks from the Eurosystem and three European supervisory authorities, when the contract with the Delegation of the European Commission to Russia was signed by my predecessor Wim Duisenberg on 13 October 2003. In embarking on this new endeavour, we were encouraged by the long-established cooperation between the Bank of Russia and several Members of the Eurosystem, and heartened by the enthusiasm with which all parties were participating in this project.

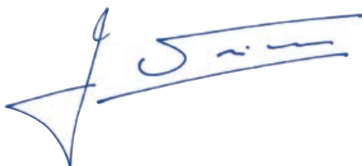
The two-year contract stipulated implementation of an extensive training programme in the field of banking supervision, with the overall aim of contributing to financial stability in the Russian Federation. More than 800 banking supervision experts from all regional branches of the Bank of Russia have been trained by EU banking supervisors. In addition, special events have been held for managers of the supervisory departments and a high-level dialogue on supervisory and financial stability challenges has been nurtured at four important seminars in Moscow. Although the benefits of a book are not comparable with those arising from bilateral dialogue between experts, the outreach of the project will be substantially increased with this publication.

Looking back, the European Central Bank and its partners have demonstrated an outstanding ability to work on this project efficiently and effectively as a team. We have been proud to share the European banking supervision experience openly with our Russian colleagues.

The project implementation has been characterised by close and candid cooperation, fully supported by all three parties involved: the Delegation of the European Commission to Russia, the Bank of Russia and the team consisting of the European Central Bank and its partners. This has been crucial for the success of the project, which in a wider context also contributes to an intense dialogue between the Eurosystem and the Bank of Russia regarding additional policy issues of common interest.

I would like to use this opportunity to express my deep gratitude to all staff involved in this project for their contributions and for demonstrating a true European spirit by acting as a united team.

I am sure that this book will provide the reader with a useful overview of both European banking supervision experience and Russian practice.



Jean-Claude Trichet
President of the European Central Bank

INTRODUCTION*

The TACIS project – Central Bank Training III – was a major training programme in scope, concentration and complexity in the field of banking supervision, based on the contract signed by the Delegation of the European Commission to Russia (Delegation) and the European Central Bank (ECB) on 13 October 2003 (The term TACIS has been replaced and is today known as the EU-Russia Cooperation Programme). The project was implemented from 1 November 2003 to 31 October 2005 and foresaw transfer of knowledge from EU banking supervisors to the supervision staff of the Bank of Russia and, by providing capacity-building in supervision, aimed more broadly at contributing to financial stability in Russia. This is in the interest of both the EU and Russia, and may further contribute to integration between the two regions as well as support the creation of a common economic space. Indeed, the "roadmaps" adopted on 10 May 2005 in Moscow on the occasion of the 15th EU-Russia Summit lead to the creation of a "common economic space", which explicitly foresees a reinforced stability of the banking and financial system, "through improvement of the legislative base, effective supervision", including the establishment of a "regulatory dialogue, with the aim to strengthening the effectiveness of the prudential regulatory system and independent supervision in accordance with the highest international standards and norms".

The project was implemented by the ECB in partnership with Banca d'Italia, Banco de España, Banco de Portugal, Banque de France, the Central Bank and Financial Services Authority of Ireland, De Nederlandsche Bank, Deutsche Bundesbank, the Financial Services Authority, Finansinspektionen, Oesterreichische Nationalbank, Rahoitustarkastus and Suomen Pankki. The training programme consisted of three components: one-week courses for supervision staff from all regions of Russia and branches of the Bank of Russia; one-day high-level seminars for senior representatives of the Bank of Russia and an external audience that included representatives from Russian ministries and political chambers, banking associations and academics; and one-week study visits for Bank of Russia managers, primarily from head office, to an EU central bank or to banking supervisors. The programme included 33 fundamental and 29 specialised courses that were attended by roughly 800 Bank of Russia supervisors. Additional background information about the TACIS project, the structure and content of the training programme is provided in annex 9.

* The Editor wishes to thank Mr. Petr Stanek of the Czech National Bank for his valuable inputs, during his stay at the European Central Bank, and Ms. Irina Zubanova for support and undertaking a thorough review and editing process on the Russian language edition of the book. The Editor is also grateful to several colleagues of the ECB and its partner institutions for their encouragement, comments and suggestions: This book greatly benefited from the work prepared by all of them for the training courses of the "Central Banking Training III" programme. Any errors or inaccuracies are, of course, the sole responsibility of the Editor. The views expressed in the book, except for chapter 8, are those of the editor and do not necessarily reflect those of the European Central Bank or its partner institutions.

This book on European Union (EU) supervision experiences and Russian practices has been developed to extend the outreach of training to Bank of Russia supervisors who were not able to attend training courses offered during the 24 months of the TACIS project. Chapter 8 of the book has been prepared by the Bank of Russia. Except for annexes 5-8, all other chapters and annexes have been prepared by the ECB in consultation with its partner institutions.

WHO SHOULD READ THIS BOOK?

The textbook aims to provide an EU perspective on supervision, e.g. through examples and anecdotes, although many of the issues addressed are indeed global and are addressed in a fashion that considers global standards. The book has been developed for:

a) New Bank of Russia supervisors who would like to know more about the features of EU supervision, and

b) Experienced, specialised supervisors who are seeking to familiarise themselves with supervisory issues outside their own field of expertise.

The latter should not expect to find much information in this book that is actually new; however, they should find the overview of EU supervision useful as well as the more detailed information contained in the annexes, plus references to websites where more in-depth information can be found.

With its primary readers in mind, the book is purposely kept short, offering the reader an overview of issues that are important from two perspectives: compliance with regulation, and processes that should be in place in banks in order to manage the risks that supervised banks face. Hence, the reader will not find a complete listing of the national supervisory practices in the different EU countries. Nor is the book a manual for the implementation of EU-inspired risk-based supervisory practices on a day-to-day basis. In fact, the reader should keep in mind that the way regulation and supervision are carried out in the EU varies quite considerably from country to country. Though regulation and supervision are based on the same EU legislation, which secures a minimum level of harmonisation, supervisors in different countries also have their own specific legislation and rules to follow.

HOW SHOULD THIS BOOK BE USED?

The book has been developed to permit the reader to carry out a self-study of EU supervision. To this end it includes a test with answers to help the reader assess whether or not he or she has understood a topic as intended. The reader can freely jump between sections or chapters of the book; it is not necessary to complete the test successfully to progress to the next topic.

The book focuses on banking supervision experiences in the EU and the structure will guide the reader through:

- Banking risk (credit, market, liquidity and operational risk);
- Regulating and supervising banks (including an introduction to the supervisory structures in the EU, the role of banking regulators versus banking supervisors, the principles of the Basel Committee on Banking Supervision ("the Basel Committee"), international bodies in supervision and financial stability, and the complementarities of compliance-based and risk-based supervision);
- Licensing of banks;
- Off-site and on-site supervision, including capital adequacy and Basel II;
- Crisis management and bank rehabilitation;
- Money laundering prevention; and
- Financial stability monitoring.

Thereafter, Chapter 8 describes the Russian banking supervision practice.

I BANKING RISK

This chapter of the textbook provides an introduction to four of the main risk categories: credit risk, market risk, liquidity risk and operational risk.[1] After reading this chapter, the reader should understand the nature of these risks and why it is important to monitor and manage them. For an analysis and discussion of sound supervisory approaches to risk in the EU, the reader should refer to Chapter 4 on off-site and on-site supervision.

Principle 13 of the Core Principles for Effective Banking Supervision states that: "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".[2]

This principle, although to some extent a simple supplementary principle to those that relate to specific types of risk[3], clearly sets out supervisory expectations towards banks in terms of their ability to identify, measure, monitor and control all risks that the bank incurs. As such, this principle represents a cornerstone in supervision, as it sets out the basic principles for supervisors seeking to check the risk management of the institutions that they have licensed. If banks do not have such a process in place (characterised for instance by transparency in internal decision-making, execution of and compliance with orders, segregation of duties, etc.), and if they do not have an accounting and reporting system that adequately identifies and measures risks, the supervisory agency has little if any chance to fulfil the supervision mandate. In short, information provided to the supervisor must be fully reliable: it is impossible for supervisors to do their job if a bank has provided incorrect data or information, either accidentally or on purpose.

1.1 CREDIT RISK

WHAT IS CREDIT RISK?

The Basel Committee defines credit risk as "the potential that a bank borrower or counterparty fail to meet its obligations in accordance with agreed terms".[4]

More specifically, the *borrower may fail because he/she is not able or willing to honour the obligation*. The ability to honour the obligation is closely linked to

1 The Core Principles for Effective Banking Supervision identify and briefly describe the following risks in banking: credit risk, country and transfer risk, market risk, interest rate risk, liquidity risk, operational risk, legal risk and reputational risk.

2 Basel Committee on Banking Supervision ("the Basel Committee"), Basel, September 1997.

3 Principles relating to specific types of risk are: credit risk (#7), the evaluation of asset quality and the adequacy of loan loss provisions and reserves (#8), concentration of risks and large exposures (#9), connected lending (#10), country and transfer risk (#11), and market risks (#12).

4 Basel Committee (2000), "Principles for the Management of Credit Risk", September.

the financial standing (creditworthiness) of the borrower, whereas *willingness* is a more intangible issue linked to the assessment of the client's personal profile.

To assess a client's creditworthiness, a bank should have a process in place whereby it can obtain sufficient information to analyse a potential borrower's monthly cash flow (income versus expenses) in order to assess the borrower's ability to meet the future contractual payments of the loan. However, although this analysis might be positive, the borrower could prove unwilling to comply with the contractual obligations agreed with the bank, and instead use the cash flow for different purposes. Banks can assess borrowers' willingness to honour obligations in several ways. Knowing the customer well helps, and a track record of honouring previous obligations or setting aside rainy-day reserves/savings can also be useful to the loan officer. The golden rule to be followed is that if the loan officer is in doubt about the borrower's ability or willingness, the loan should not be granted – irrespective of whether the loan can be secured with collateral.

Credit risk – or counterpart risk as it is also often termed – arises for holders of financial instruments where there is a counterpart that is obliged to pay a certain amount at agreed conditions, irrespective of whether the instrument is accounted for on or off-balance sheet. Most instruments carry credit risk, such as:

– a loan or credit, where the borrower represents the credit risk;

– a guarantee (financial or performance bond, for instance), where the issuer represents the credit risk;

– a bond, where the issuing entity represents the credit risk;

– a financial derivative (e.g. futures[5], forwards, options, swaps), where the holder has a credit risk on the party with a payment obligation; and

– trade finance instruments such as letters of credit or promissory notes, where the holder has a credit risk on the party with a payment obligation.

One exception is a share that, although issued by a company, does not oblige the company to pay an agreed sum to the holder at specified terms. The share does not have a maturity or contractual payments; dividends are voluntary and may be cancelled at the company's discretion. Nevertheless, the creditworthiness of the company will influence the price of the share.

An important related question to understanding precisely what constitutes credit risk is *what constitutes a borrower*. Obviously, the borrower is the person or

5 On futures, credit risk is limited because of the daily settlement of margin calls, which reflect movement in prices.

company that signs the loan contract: the question is whether it is sufficient to look only at the direct counterpart. Consider a situation where a bank has granted a loan to company X and a loan to company Y, both of which are owned by company Z. Should these loans be considered as granted to each single company? Or should the bank rather consider these two loans as granted to one and the same ultimate entity (company Z) when analysing the creditworthiness of the borrower? In the EU, a supervisor should consider both situations – the single entity and the group of related entities. The ultimate credit risk and creditworthiness relate to the whole group, irrespective of the existence (or not) of guarantees from the parent company on loans taken out by subsidiaries. In addition, lending to related borrowers represents a concentration of credit risk on which the bank should be well-informed (even beyond related borrowers and into industry sectors, as credit risk tends to develop equally for all companies in one sector).[6]

Capital adequacy requirements differ for credit risk, depending on whether the bank incurs the risk as part of its trading activities (there are different regulations for trading book activities, where banks have to hold additional capital for counterparty risk arising from trading book positions and non-trading book activities) or as part of its banking activities (which are subject to capital requirements under both Basel I and Basel II). When credit risk is incurred as part of banking activities and recognised in the so-called Banking Book, capital requirements under the Basel I principles differ from 0 to 8 of an outstanding amount of 100. The calculation of capital requirements is based on weighting the risk of the counterpart and/or instrument. In general, the risk weight for exposures to government is 0% (no capital required), compared to 20% for banks in OECD countries (1.6 in capital on a loan of 100), and 100% on companies and households (the capital requirement is 8 for a loan of 100). Certain types of instruments may qualify as less risky than a risk weight of 100%, e.g. guarantees and residential real estate mortgage loans. For more information about capital requirements in Basel I and II, see Chapter 4 on off-site and on-site supervision.

WHY IS IT IMPORTANT TO MONITOR CREDIT RISK?

The importance of monitoring credit risk is succinctly stated in a Basel Committee paper on "Principles for the Management of Credit Risk": "While financial institutions have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties. This experience is common in both G-10 and non-G-10 countries". In other words, empirical evidence shows that insufficient attention paid to the identification, measurement, management and control of credit risk *is*

6 Core Principle for Effective Banking Supervision No 9 stipulates: "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". (Basel Committee, September 1997).

the major cause of bank failures – and hence sufficient reason to pay particular attention to this aspect.

A bank must have *timely and precise information about the credit risks in its existing exposure*. A lack of overview will make it difficult to assess the quality of assets and hence the need for provisions against expected losses. Insufficient provisions against expected losses can lead to an extra strain in bad times, when profitability tends to be strained. It should be remembered that capital is designed as a cushion against unexpected losses and is not intended to cover expected losses.[7] The lack of timely and precise information about credit risk will furthermore make it almost impossible for the bank to assess whether or not to extend an additional loan to a specific borrower, and if so, on what conditions (margin, maturity, etc.).[8]

As an example, the lack of timely and precise information caused serious problems for a bank in Denmark. This bank was created through the merger of three medium-sized institutions. The merging institution did not make it a priority to obtain a sufficient overview of exposures to groups of companies and credit risk exposure to economic sectors. Rather, the bank continued to add to a credit portfolio that, even at the time of the merger, was already skewed and concentrated on high-risk sectors (e.g. commercial real estate and real estate development) that are particularly sensitive to cyclical developments. When the economic cycle changed and the creditworthiness of clients declined substantially, the bank experienced major problems managing these portfolios.

A bank should not, however, purely focus on knowing its own risks vis-à-vis a borrower. To ensure a proper assessment of each borrower's creditworthiness, it is paramount that the bank has information about the borrower's total exposure/leverage, including for instance the borrower's loans from other banks, etc. This implies a *continuing monitoring of all counterparts* as part of assessing the ultimate need for loan loss provisions. This monitoring should also include elements of how economic developments generally impact the creditworthiness of the individual client as well as the group that the client is part of (e.g. the impact that low growth and increasing unemployment can have on households' ability to service debt). In terms of collecting information on borrower exposures, some EU countries have central credit registers, which log information from banks on loans granted to companies or groups of companies or households. These registers can assist banks in their analysis. Other countries can rely on information from tax return forms, as banks report loans and interest payments

7 Additional information on expected losses and unexpected losses can be found in chapter 4 in the section dealing with capital adequacy and Basel II.

8 Additional information on the importance of information on the bank's exposure to individual clients can be found in Basel Committee (2004), "Consolidated KYC Risk Management", October (available at www.bis.org/bcbs)

on such loans to the relevant tax authority. When none of these objective sources of information is available, the mutual trust between bank and borrower should allow the bank to obtain a full overview of the exposure of the client.[9]

Supervisors seeking to detect weaknesses in banks' management of credit risk are recommended to read the Basel Committee paper "Principles for the Management of Credit Risk" (appended to this book). It includes an annex that lists the common sources of major credit risk problems under three headings: concentrations, credit process issues plus market, and liquidity-sensitive credit exposures.

1.2 MARKET RISK

WHAT IS MARKET RISK?

The Basel Committee defines market risk as "the risk of losses in on- and off-balance sheet positions arising from movements in market prices".[10]

Typically, a distinction is made between four main types of market risk:

– *Interest rate risk*, which is the risk that arises for the holder of an interest-bearing position. An example of this risk is a bank that purchases an interest-bearing fixed-maturity bond for its own portfolio. When market interest rates change, the market value of the bond changes. A loss arises when market interest rates increase and the value of the bond decreases, as the discounted future cash flow has a resulting lower present value.

– *Currency risk*, which is the risk that arises for the holder of a position denominated in a non-domestic currency. An example of this risk is a bank that grants a loan in a non-domestic currency. A loss arises when the domestic currency appreciates in value on the exchange markets, resulting in a loss of value on the loan (measured in domestic currency).

– *Equity risk*, which is the risk that arises for the holder of an equity position. An example of this risk is a bank that has purchased shares/equities in a company. A loss arises when the share/equity, for instance one traded on a stock exchange, is fixed at a lower market value.

– *Commodity risk*, which is the risk that arises for the holder of a commodity position. An example of commodity risk is a bank that has purchased gold. A loss for the bank arises when the price of gold is fixed at a lower level in the commodities markets.

9 A particularly notable example of a lack of overview of total company exposure was the failure of the American hedge fund Long Term Capital Management (LTCM), which sent shockwaves through the American financial markets, prompting intervention by the US Federal Reserve to protect financial stability. Various descriptions of the LTCM case can be found on the internet (e.g. on www.erisk.com/learning/casestudies).

10 See for instance Basel Committee (1996), "Amendments to the Capital Accord to Incorporate Market Risks", January.

– *Settlement and counterparty risk*, which is the risk that arises on transactions in interest rates, currency, equities or commodities that have not yet been settled. An example is a bank that has purchased a share from another bank that is not the issuer of the share, but which has to deliver the share to the purchaser against payment. A loss arises for either party in the transaction if settlement does not occur.

The accounting regime followed by an individual bank determines whether and how quickly the bank effectively realises market risk losses in its financial statements. Typically, European banks recognise losses because they follow a regime of measurement at “the lower of the cost or market price”, whereas gains are not recognised. The treatment of losses due to interest rate risk can differ from that of the other market risks depending on whether the bank’s position arises from its trading activities (trading book) or its lending and deposit-taking activities (banking book). Accounting regimes that allow the use of market values to fix the price of positions, such as the International Financial Reporting Standards (IFRS) defined by the International Accounting Standards Board (IASB), typically require banks to realise both losses and gains on market risk positions.

Irrespective of the recognition and measurement regime followed for accounting purposes, market risks are subject to prudential and capital requirements under the Basel I framework and under the EU rules embedded in the Capital Adequacy Directive.

Market risk arises on assets/liabilities held on or off-balance sheet, as well as on derivatives. Derivative instruments include the following four products:

– *Options*, where the buyer of an option has the right at any time during a fixed period (American option) or at a fixed point in time (European option) to buy (call) or to sell (put) an agreed amount of an underlying asset at a fixed price. To obtain this right, the buyer pays a premium to the seller of the option.

– *Futures*, where two parties agree at a certain point in time to exchange an agreed amount of an underlying asset at a fixed price. Unlike options, futures imply that the asset must be exchanged at the fixed price on the expiry date.

– *Forwards*, which are similar to futures except that they are not traded on markets but are bilateral agreements between two parties. Because of this, forwards are not restricted to the specified maturities that are available on futures. Forward rate agreements (FRAs) are a sub-set of forwards that, as the term indicates, relate to interest rate agreements.

– *Swaps*, where two parties agree to exchange streams of payments under specified terms over an agreed period. A common swap type is an interest

rate swap, in which one party agrees to pay a fixed interest rate in return for receiving a variable rate from the counterpart.

WHY IS IT IMPORTANT TO MONITOR MARKET RISK?

As with all other risks that a bank takes, the primary reason for identifying, measuring, monitoring and controlling market risk is that *the bank can incur a loss on the position taken*. Excessive risk-taking can lead to the failure of the institution if markets move against the bank. If for instance the bank expects lower interest rates in the future and has positioned itself to take advantage of this situation, e.g. by swapping variable rates for fixed interest rate payments, and market rates actually increase, then the bank will incur a loss. The supervisor expects the bank to know its position upfront and, if necessary, to hold sufficient capital against unexpected losses.

Markets are fundamentally volatile and timely information is essential, as the prices of positions in financial markets can change rapidly. In stock markets, for instance, market sentiment tends to lead to overshooting and undershooting of prices. One reason is the so-called lemming effect, where many investors simply follow the prevailing trend, in the belief that the trendsetter has proprietary information justifying the higher (or lower) price of an asset. On the other hand, markets tend to react violently in the opposite direction if they discover that there is no justification for the higher price of an asset, pushing the stock below an economically justifiable level before it eventually recovers to the equilibrium. Such swings may not be limited to individual companies but can affect the entire domestic stock market, or even the global market. The best recent example of this is the bursting of the new economy asset price bubble, which primarily stemmed from an overvaluation of the technology, media and telecommunications sectors.

As *financial markets become increasingly global and complex,* correlations in price movements across countries in similar instruments and on similar counterparties increase, and the depth and diversity of the market can benefit overall stability through portfolio diversification. However, integration can also lead to increasing volatility and cyclicality when prices move in parallel. Understanding financial markets with regard to interest rates, foreign exchange, equities and commoditiest is important for banks in their pursuit of profit, as well as to manage market risk. Financial derivatives continue to develop (swaptions, caps, floors, etc.) and existing as well as new products offer new possibilities for banks to manage their risks, many of which can be hedged effectively. The *complexity of instruments* is at the same time a major challenge, and banks should not enter into transactions without understanding the risks involved in a specific instrument.[11]

11 The collapse of Barings Bank due to its exposure to financial derivatives is a clear example of a lack of prudent oversight of its market risks. For a description of the Barings debacle, see www.erisk.com/learning/casestudies.

1.3 LIQUIDITY RISK

WHAT IS LIQUIDITY RISK?

The Basel Committee defines liquidity risk as: "the inability of a bank to accommodate decreases in liabilities or fund increases in assets".[12]

There is no specific capital charge for liquidity risk, although liquidity is crucial for banks, as being illiquid is as dangerous as being insolvent to a bank. Although the EU has no common framework for liquidity risk management, supervisory expectations towards banks build on largely equal underlying principles, which focus on mismatched positions. Financial instruments held on or off-balance sheet have different liquidity features, and all of these count in the mapping of liquidity risk (inflows and outflows of liquidity in different maturity bands). The liquidity of individual financial instruments relates first and foremost to their maturity, but also to how quickly they can be redeemed under extreme scenarios by customers (liabilities) or by banks (assets), irrespective of the original maturity. To give an example, a five-year German government bond is more liquid to hold for a bank than a one-year loan to a small German company, as the bank can more easily sell the government bond than the loan if it needs to raise liquidity to meet a shortfall in funding.

As liquidity is crucial to all banks, supervisors expect banks to *develop an appropriate strategy for liquidity risk management* that addresses aspects of identification, measurement, management and control. The strategy should include a process for ongoing measurement and monitoring of net funding requirements (with limits on liquidity positions, for example) and for day-to-day management. The strategy should be tailored to the sophistication of the bank, its business nature and complexity, and must have appropriate Board oversight and identification of responsibilities for implementation. At internationally active banks, such a strategy could for instance include centralised liquidity oversight and management across countries and currencies, building on timely information processed by information systems. It could also include stress-testing of liquidity developments, assuming different scenarios, and a periodic review of assumptions made in such scenarios. Contingency plans for handling liquidity crises should be drawn up, and should include an assessment of and strategy for access to possible new market sources. Supervisors expect banks to have in place a strategy that spells out minimum levels of liquidity and that allows the bank to maintain such a level even in extreme circumstances.

The process whereby banks map their liquidity position in different maturity bands in order to identify maturity mismatches in assets and liabilities (including off-balance sheet positions) as well as in different currencies is often referred to as a maturity ladder. This ladder is designed to allow the bank to predict cash inflows as well as cash outflows.

12 Core Principles for Effective Banking Supervision, Basel Committee, Basel, September 1997.

In general, supervisory expectations with regard to banks include:

- Daily measurement and over time
- Use of the maturity ladder to identify potential shortfalls
- Use of stress tests on maturity ladders
- Assessment and estimation of the quality of liquid assets, including a possible discount (haircut) to be expected in distressed sales
- The bank's ability to access new liquidity sources from retail, commercial/wholesale or interbank markets
- The level of lines that have not yet been drawn (i.e. a committed credit line from another bank on which the bank has not yet drawn funds) and the ability of the bank to expand/keep these lines under critical conditions
- Contingency planning related to:
  - the difficulties of calling on lines that have not yet been drawn on;
  - support from owners (e.g. parent company);
  - central bank support, although in their contingency plans banks should not explicitly count on central bank support, as this raises moral hazard issues; and
  - the level of liquid and redeemable assets held.

WHY IS IT IMPORTANT TO MONITOR LIQUIDITY RISK?

One of the key roles of banks is indeed liquidity transformation, as banks transform short-term deposits/funding (liabilities) into long-term loans and credits (assets). Banks need to manage their business carefully, including their liquidity situation, to benefit from continued *trust by depositors*, which in turn ensures that depositors will continue to fund the bank's activities. A loss of trust can lead to a bank run, where depositors line up outside banks or at ATMs to withdraw deposits, thereby making extreme liquidity demands on a bank. In such a scenario, the bank can increase funding from other activities, e.g. borrow in the market to honour clients' demands, or quickly reduce assets through selling or redemption. Another source of funding is in the interbank market, where banks lend to each other. However, such funding typically dries up very quickly in periods of extreme liquidity demand, which means that banks that depend on interbank funding to operate and fund business activities are typically considered vulnerable in a liquidity assessment.

All banks are therefore faced with a delicate balance in which they must on the one hand attract a stable funding base, and on the other need to invest in assets, at least some of which can be redeemed at relatively short notice. They are also faced with the choice between rapid growth in assets and not being able to fund this growth with long-term and stable funding, relying on other banks to place their excess liquidity with them. Banks also need to make choices in terms of profitability. Longer-term and stable funding is usually more expensive than short-term demand deposits, thereby squeezing profit margins. Moreover, liquid assets (such as bonds) typically earn a lower margin than long-term loans.

Sound liquidity management can reduce the probability that serious difficulties at individual banks could lead to financial stability problems, as liquidity problems in one bank can have system-wide implications through the interbank market. Such a situation could occur because banks, through the interbank market, lend to each other and the failure of one bank thereby could spill over to other banks (the domino effect) that have outstanding deposits with the failing bank. In the EU, where many banks and financial conglomerates operate cross-border, system-wide implications could arise in different countries.

1.4 OPERATIONAL RISK

WHAT IS OPERATIONAL RISK?

The Basel Committee defines operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems, or from external events. The definition includes legal risk as a risk of loss resulting from a failure to comply with the law, as well as prudent ethical standards and contractual obligations and exposure to litigation. However, it excludes strategic and reputation risk.

Discussions of operational risk started in the late 1990s, and were finally elaborated and incorporated into the New Capital Accord (Basel II). Banks' management had during this time started to recognise various types of operational risk and tried to prevent fraud and failures and to reduce errors in transaction processing. With the Basel II, the approach to operational risk management is now comparable with those applicable to credit and market risk management procedures and assessments.

WHY IS IT IMPORTANT TO MONITOR OPERATIONAL RISK?

The globalisation of financial services, together with increasing technological sophistication, has impacted the activities of banks, making them more diverse and complex. Internationally operating banks are exposed to more than just credit risk and market risk. Banking services are faster, and the branches and separate banks in banking groups are connected through complicated information systems and networks that can substantially influence the performance of each particular financial institution. The failure of any factor, be it human or technical, can lead to losses and significantly damage the position of an institution.

The basic types of operational risk events are as follows:

- *Internal fraud* (misreporting of positions by dealers, insider trading, employee theft, misinterpretation of credit applications in the case of bribed employees)

- *External fraud* (robbery, forgery, computer hacking, credit fraud, payment card frauds);

- *Employment practices and workplace safety* (employee health issues, general liability for employees and compensation claims paid to employees);

- *Clients, products and business practices* (misuse of confidential information, sale of unauthorised products by banks, money laundering and fraudulent activities using accounts);

- *Damage of tangible assets* (vandalism, terrorism, earthquakes, fires, floods);

- *Business disruption and system failures* (hardware and software failures, telecommunication problems);

- *Execution, delivery and process management* (errors in data entry, incomplete legal documentation, collateral management failures, unauthorised access to a client's account).

Proper operational risk management requires not only the correct identification of risk, but also extensive data collection and evaluation of the impact of various events. If detailed comparable data are available, then similar quantitative approaches can be applied to operational risk management, such as those successfully used for other banking risks.

The method and emphasis on operational risk processing can vary from bank to bank in accordance with each bank's respective risk profile, size and type of business. However, Basel II already defines unified basic rules for measuring operational risk. The accord introduces three measurement methodologies to calculate the capital charge a bank should hold to cover its operational risks:

- The basic indicator approach

- The standardised approach

- The advanced measurement approach.

In the case of the *basic indicator approach*, the bank is simply obliged to hold capital at a level of 15% of the average positive annual gross income in the

previous three years. The percentage called alpha is determined by the Basel Committee.

The *standardised approach* divides the bank's activities into eight business lines: corporate finance, trading and sales, retail banking, commercial banking, payment and settlement, agency services, asset management and retail brokerage. The gross income within each business line forms the basis for calculating the percentage amount determined for each particular business line separately. The percentage called beta varies from 12% to 18%, depending on the risk profile of each business area. The total capital charge is then calculated as the three-year average of the sum of capital charges across each of the business lines in each year.

The *advanced measurement approach*, which is based on a bank's own sophisticated methodology of capital charge calculation, can only be used by banks that are compliant with the set of qualitative and quantitative standards. The bank's management has to convince the supervisor about the soundness of the measurement system, data collection quality, control mechanisms, proper assessment using scenario analysis and the organisation of operational risk management.

All of these approaches vary in terms of their sophistication and risk sensitivity. Smaller banks are not expected to develop hugely sophisticated, expensive systems, in contrast to large internationally active banks that process large amounts of transactions.

WHAT SHOULD BANKS AND SUPERVISORS DO?

The supervisory role is significant in the process of proper operational risk management. The supervisor should require banks to develop an operational risk management framework adequate to the size, risk profile and complexity of banking services provided by the bank. Supervisors should regularly and independently evaluate the bank's policy, procedures and practice related to operational risk. In particular, they should review:

– The effectiveness of the risk management process and control system with respect to operational risk;

– The bank's methods for monitoring and reporting its operational risk profile, especially data on operational losses;

– The bank's procedures for resolving operational risk events;

– Internal controls, reviews and audit that ensure the integrity of the operational risk management process;

– The effectiveness of mitigation efforts (insurance) in minimising risks;

– The quality of disaster recovery and business continuity plans; and

– The process for assessing overall capital adequacy for operational risk.

Proper operational risk management is only possible if adequate data collection is everyday practice. Information should be collected on:

– The loss amount (the damage amount);

– Description of the loss event;

– Type of loss event;

– Place where the loss was reported and expensed;

– Date of loss and discovery date of loss;

– Management action;

– Insurance and other recoveries; and

– Total loss estimate after possible recoveries.

A sufficient database of operational loss events enables banks to estimate risk more precisely and to avoid unexpected losses that could prove fatal. However, operational risk procedures are still rather new to many banks and require further development. Potential operational risk loss events are unforeseeable and entail much higher level of uncertainty compared to other banking risks.

2 REGULATING AND SUPERVISING BANKS

The first section of this chapter describes the importance of regulating and supervising banks in a market economy. Subsequent sections address: banking supervision and the organisational structures for supervision in the European Union; the role of a banking regulator versus a banking supervisor; the internationally recognised principles for banking supervision, as well as international bodies and fora which play a key role in developing the framework of standards and practices that contribute to banking and financial stability; and a description and discussion of the different and complementary aspects of compliance-based and risk-based supervision.

After reading this chapter, the reader should have a better understanding of:

– the role that banks play in a market economy, and why there is a need to regulate and supervise these banks;

– the different models of supervision in the EU;

– the difference between a banking regulator and a banking supervisor;

– international banking supervision principles as well as the bodies and fora which develop the principles, practices and recommendations that contribute to financial stability; and

– risk-based supervision as a contributor to compliance-based supervision in fulfilling the supervision mandate.

WHAT IS THE ROLE OF BANKS IN A MARKET ECONOMY?

In a market economy, banks provide means of clearing and settling payments to facilitate trade; they collect and hold savings/deposits of households, firms and government; and they use this funding to grant credits for investment purposes. As such, banks are financial intermediaries that can be seen as engaging in:

– *Volume transformation,* whereby small individual deposits are transformed into large-sum loans;

– *Maturity transformation,* whereby short-term deposits are transformed into long-term lending;

– *Liquidity transformation,* as banks transform liquid deposits into illiquid loans;

– *Risk transformation,* whereby a depositor's demand for repayment security is transformed into the risk for the bank that the lender will not repay the loan; and

– *Regional transformation,* whereby high levels of saving in one region/country are transformed into high lending activity in a different region/country.

In carrying out these transformation activities, banks benefit from economies of scale in gathering information from a large number of depositors, borrowers and market participants that is not available to each single depositor of the bank and would be too costly to acquire. In economic theory this is often referred to as the role of "delegated monitoring": on behalf of their depositors, banks tackle asymmetric information problems in financial transactions.[13]

More generally, one can also say that banks manage the "blood" that helps keep the real economy of goods and services alive. They manage the capital flows from savers, and take on risks in connection with this intermediation process. When market elements work properly, banks optimise capital flows under risk/return perspectives and thereby support the economy by providing loans for profitable investments. As intermediaries, banks also play an important role in the monetary policy transmission process.

Thus, the role of banks in market economies is fundamentally different to the one in centrally planned economies. In centrally planned economies, banks are merely responsible for passively accommodating and monitoring financial transactions between enterprises, as dictated by the central planners. In market economies, on the other hand, banks play a key role in the coordination of economic activities, acting as profit-maximising institutions that decide who they wish to do business with and thus what risks they wish to take. A basic feature in this decision-making process is indeed not only the assessment of the return, but also the risk of engaging in business with a specific counterpart. (See Chapter 1 for an introduction to banking risk.)

In carrying out these activities, banks can be organised in different ways. In addition to engaging in the business of deposit-taking and lending, banks in the EU are often involved in payment transactions (cash or cashless, domestic or international) and in securities transactions, as well as the safekeeping of securities (custodian services). An overall distinction is made between so-called universal banks and specialised banks. Universal banks include all types of activities within one legal entity, whereas specialised banks tend to concentrate on one or more specialised functions, such as conducting mortgage-lending activities. More information about the banking systems in the EU and the differences between them can be found on the ECB's website (www.ecb.int).[14]

13 See D. W. Diamond (1984), "Financial Intermediation as Delegated Monitoring", *Review of Economic Studies*, 51, pp. 393-414, as well as R. C. Merton and Z. Bodie (1995), "A Conceptual Framework for Analyzing the Financial Environment", in D. B. Crane et al. (eds), *The Global Financial System: A Functional Perspective* (Boston: Harvard Business School Press), pp. 3-32.

14 Two examples are the "Report on EU Banking Structure 2004", released on 24 November 2004 and the report "Banking Structures in the New EU Member States", from 31 January 2005.

WHY REGULATE AND SUPERVISE BANKS?

Banks play a crucial role in the efficient allocation of savings and investments in a market economy and are important for the stability of the whole financial system. Because banks take risks in fulfilling this function, they can fail and potentially go bankrupt. When this happens, depositors lose their savings, which can have devastating implications for public trust in the whole banking system. Given that banks play a pivotal role for the real economy in providing ways of clearing and settling payments, transforming claims in terms of volume, maturity, liquidity, risk and region, and acting as delegated monitors, a primary reason for regulating banks is to maintain confidence and trust in the banking system by setting minimum standards for the safety and soundness of the operation of banks.[15]

Standards for the safety and soundness of banks are developed at international level and are, in most countries, transformed into national legislation. These standards typically take the form of principles or recommendations and are not legally binding in themselves. The Basel Committee is the most prominent example in this context, and its organisation and the Core Principles for Effective Supervision are mentioned later in this chapter.

On the basis of national legislation, the banking regulator can issue regulations to banks that they have to comply with. Through off-site analysis and on-site inspections, the banking supervisor monitors that banks comply with these regulations (compliance-based supervision) and checks that banks have in place sound practices for the identification, monitoring, management and control of banking risks, to satisfy the supervisor that the bank will not face serious problems in the foreseeable future (risk-based supervision). This dual regulatory and supervisory function is typically performed by a single public authority. More details on compliance-based and risk-based supervision as well as on the role of regulators versus supervisors are provided later in this chapter.

Traditionally, supervisors have focused on compliance issues, where the requirement to hold minimum capital against banking risks (capital adequacy) still remains the cornerstone. Gradually and in connection with the evolving complexity of banks' activities, the focus has turned increasingly to sound risk management and a focus on possible future threats to the viability of an institution. In this context, it is important to emphasise that banks have three main lines of defence to cover losses that may arise from their activities:

(a) good management and sufficient profitability to absorb losses;

(b) proper provisioning practices that set aside reserves to cover expected losses; and

15 See also M. Dewatripont and J. Tirole (1994), *The Prudential Regulation of Banks*, The Walras-Pareto Lectures, Vol. 1 (Cambridge, MA: MIT Press).

(c) adequate capital and equity reserves to cover unexpected losses.[16]

These three main lines of defence highlight the fact that supervisors should be interested in and concerned with the ability of bank management to ensure that banks operate in a safe and sound manner that goes beyond purely technically complying at any given moment with the existing rules and regulations.

2.1 BANKING SUPERVISION AND THE ORGANISATIONAL STRUCTURES FOR SUPERVISION IN THE EU

WHAT IS THE ROLE OF THE SUPERVISOR AND BANK MANAGEMENT?

Banking supervisors play an indirect role in protecting depositors against losses arising from the failure of an individual bank. Direct responsibility lies with the bank's management, who have to ensure, under monitoring by the supervisors, that they are responsible and are able to meet depositors' demands for repayment. Nevertheless, the role of the supervisor can substantially influence the quality and soundness of the banking system, and the supervisor can for instance play a role in educating bank managers on how they may fulfil their responsibilities towards stakeholders. One contribution that the supervisor can make is to express clearly to managers what principles and processes the bank should have in place in order to identify, measure, monitor and control banking risks. The supervisor must tread a delicate balance between helping bank managers understand and develop such principles and processes, and at the same time avoid being too prescriptive and thereby performing a management function for the bank.

WHY ARE NATIONAL SUPERVISORY STRUCTURES CHANGING?

There is an increasing need for coordination between supervisors working in different financial sectors in a country, given the growing complexity of the banking business and the tendency of companies to form financial conglomerates covering banking, insurance and securities markets. These structural developments have resulted in more interconnections between previously separated financial services activities and therefore a higher possibility that problems in one sector could contaminate another sector or indeed the whole spectrum of financial sectors. The need for increased coordination also extends beyond borders, an area in which banks have expanded rapidly.

In some EU countries this has led to the creation of a single supervisory authority that combines responsibility for the different sectors. Other countries, faced with similar market developments, have increased their central bank's supervision mandate and formalised structures for coordination between supervisors. In a

16 As defined by J. Caruana, Chairman of the Basel Committee on Banking Supervision and Governor of Banco de España, at the occasion of the TACIS High-Level Seminar on the role of central banks in financial stability monitoring at the Bank of Russia, Moscow, on 29 September 2004.

third scenario, others have adopted a "twin peaks" supervisory model, which assigns supervisory tasks to two distinct agencies with separate objectives: one agency being responsible for safeguarding the prudential soundness of financial intermediaries, and the other agency focusing on the conduct of business with a view to ensuring transparency. Variations of the latter model can for instance be found in Italy and the Netherlands.

HOW ARE EU SUPERVISORS ORGANISED?

At present, various models for financial supervision – anchored in the central bank, a single supervisor model, or a mixed model – exist in the EU, none of which can be considered the optimal theoretical approach. The national challenge is to choose a model that is politically feasible, effective and efficient and that fits the domestic financial structure. More information on the organisation of supervision in the EU can be found on the ECB's website (www.ecb.int) in a publication from June 2003 entitled "Developments in national supervisory structures", which includes a description of developments country by country.

Table 2.1 provides a snapshot of the organisation of supervision in the 25 EU Member States. The table builds on the above referenced publication, supplemented, for the purpose of this book, by a review of information made available by competent authorities in different EU countries. The table has four columns, three of which indicate the responsibility for supervision of the banking sector, the insurance sector and securities market activities, and a fourth that indicates whether the national central bank is involved in the supervision process. A "yes" in this column signifies national central bank involvement in one or more of the following three points: 1) the management of the supervision authority, 2) the tasks of the supervisor or 3) sharing of resources with the supervisor. The EU countries are listed in alphabetical (English) order in the rows. The following abbreviations are used in the table:

- FSA (financial supervision authority) is used as an indication that a single supervisory agency exists that covers all three financial sectors.

- NCB (national central bank) is used to indicate that the central bank is responsible for supervising a particular sector.

- B, I or S (banking, insurance and securities) is used to indicate that a separate authority is responsible for supervision of a particular sector. When these letters are used in combination, they indicate a single authority is responsible for the sectors that the letter represents.

- G (government) is used to indicate that a government department is responsible for the supervision of the particular sector.

Table 2.1 National organisational structures for supervision in the EU

	Banking	Insurance	Securities	NCB involved
Austria	FSA	FSA	FSA	Yes
Belgium	BS	I	BS	Yes
Cyprus	NCB	G	S	Yes
Czech Republic	NCB	IS	IS	Yes
Denmark	FSA	FSA	FSA	No
Estonia	FSA	FSA	FSA	Yes
Finland	BS	I	BS	Yes
France	B/NCB	I	S	Yes
Germany	FSA	FSA	FSA	Yes
Greece	NCB	I	S	Yes
Hungary	FSA	FSA	FSA	Yes
Ireland [1]	FSA	FSA	FSA	Yes
Italy	NCB	I	S [2]	Yes
Latvia	FSA	FSA	FSA	Yes
Lithuania	NCB	I	S	Yes
Luxembourg	BS	I	BS	No
Malta	FSA	FSA	FSA	Yes
Netherlands [3]	NCB	NCB	NCB	Yes
Poland	NCB	I	S	Yes
Portugal	NCB	I	S	Yes
Slovakia	NCB	IS	IS	Yes
Slovenia	NCB	G	S	Yes
Spain	NCB	I	S	Yes
Sweden	FSA	FSA	FSA	Yes
United Kingdom	FSA	FSA	FSA	Yes

1) In Ireland, financial regulation is conducted by the Irish Financial Services Regulatory Authority which is an autonomous section of the Central Bank with its own board and its own responsibility.
2) In Italy, the law establishes that the Banca d'Italia is responsible for the supervision of financial intermediaries in the securities sector for matters regarding risk containment and financial stability, while the securities market supervisor, CONSOB, is in charge of transparency and conduct of business.
3) In the Netherlands, De Nederlandsche Bank (the Dutch central bank) is responsible for prudential supervision of all financial intermediaries, whereas a separate agency is responsible for supervising transparency and the conduct of business.

2.2 THE ROLE OF A BANKING REGULATOR VERSUS A BANKING SUPERVISOR

WHAT IS THE DIFFERENCE BETWEEN A BANKING REGULATOR AND A BANKING SUPERVISOR?

Regulation and supervision together form a basic part of the surveillance of the banking sector. However, it can be difficult to distinguish clearly between the two terms, and the fact that they tend to be used interchangeably does not

aid clarity. This section attempts to outline the key differences and similarities between the two roles.

The banking regulator issues the rules that banks have to comply with. Building on the national banking code or law and international principles, as well as applicable laws, the banking regulator stipulates the legal and reporting frameworks to be followed by banks. In defining these frameworks, due attention is paid to the information needs of the regulatory body to ensure that it can fulfil its tasks. The regulatory function is usually split between parliament, government and the regulatory body itself. Whereas parliament sets up the general legal framework (banking code), and the government issues additional rules that generally apply to all economic sectors (accounting principles), the regulatory body itself (typically the central bank, an integrated or specialised body) issues specific provisions that only apply to the regulated entities; in the case of a banking regulator, this is the banking sector. In the EU context, the national banking codes of each EU Member State are a transposition of the Consolidated Banking Directive (2000/12/EC), which secures minimum harmonisation of banking legislation across the EU, but not full harmonisation (the full text of this Directive is appended to this book). Regulation issues by national banking regulators are not subject to harmonisation, and for this reason national differences exist within the EU. The next section of this book provides information on a framework of committees in the EU that among other things is designed to make such national differences converge.

The banking supervisor functions as a controller. The supervisor's main target is to ensure that the legal framework provided by the regulator is properly applied by banks and other regulated entities, as well as to enforce the legal framework in case of shortcomings on the part of banks. The enforcement function is one of the key elements that contribute to the maintenance of public confidence in the banking sector. While the regulating function is usually split between two or more institutions, the supervision function for a specific sector is typically given solely to the supervisory body.

Banking surveillance has two main responsibilities: to the public, with the aim of ensuring financial stability and the soundness of the banking system, thereby supporting the national economy; and to individuals, depositors and creditors, in order to protect their rights. There are, however, certain limitations to surveillance. A banking supervisor cannot influence or enter into/interrupt business contracts between banks and their counterparties.

As the banking business of banks is taking on an increasingly global character, the need for convergence/harmonisation of national rules and regulations to create or maintain a level playing-field among competitors has become increasingly important. In the EU, the introduction of the euro as the single currency for 12 of the 25 EU Member States and the creation of the single market for financial services represent significant milestones that have provided

considerable impetus to financial market integration, leading to increased competition that benefits consumers.

The next section looks in more detail at the role played by international professional organisations in fostering common principles. The need to follow such principles is not merely justified by the fact that this will ensure that the banking system remains comparable, compatible and competitive, but also because these principles have become a cornerstone in the assessment of a country's financial sector stability by international financial institutions such as the International Monetary Fund (IMF) or the World Bank. A bank that is poorly regulated and supervised can experience substantial difficulty in global cooperation and can struggle to obtain credit lines to do business with foreign banks, even though the bank, viewed in isolation, may be well managed and financially fit.

2.3 INTERNATIONALLY RECOGNISED PRINCIPLES FOR BANKING SUPERVISION

Instability or a poor banking system in one country can negatively influence financial stability not only in that country but also internationally. The Core Principles for Effective Banking Supervision ("the Core Principles") is a document prepared by the Basel Committee on Banking Supervision ("the Basel Committee")[17] in close cooperation with the Group of Ten (G10) central banks and additional supervisory authorities. They supplement the so-called Basel Concordat, which deals with international supervisory cooperation. Whereas the Core Principles were originally developed for internationally active banks, they have, as described in the previous section, become the benchmark for assessing the effectiveness of supervision by international financial institutions.

WHAT IS COVERED BY THE CORE PRINCIPLES?

The Basel Committee issued the Core Principles in September 1997. They comprise 25 basic principles that form the foundation for the establishment and effective functioning of banking supervision. (These Core Principles are appended to this book.) Extending over 44 pages in the English version, the Core Principles address the following main areas:

- 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

17 The Basel Committee is a committee of banking supervisory authorities established by the central bank governors of the G10 countries in 1974. It consists of senior representatives of banking supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK and the US.

- Information requirements – Principle 21
- Formal powers of supervision – Principle 22
- Cross-border banking – Principles 23 to 25.

The principles are understood as minimum requirements to be implemented in national legislation. They can significantly support the efforts of public authorities and international institutions to strengthen the stability and soundness of the banking systems worldwide. The Basel Committee believes that the implementation of the Core Principles can help to improve financial stability nationally as well as internationally.

WHAT ARE THE PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION?

The basic precondition for effective banking supervision is a clear definition of the responsibilities, authorities and objectives of each supervision agency, which should also be independent and legally protected. Banking supervision can only be effective if it works within a suitable macroeconomic frame with a sound and sustainable macroeconomic policy, a well-developed infrastructure, effective market discipline, procedures for the efficient resolution of problems, and a mechanism for providing an appropriate level of systemic protection.

WHAT SHOULD BE COVERED IN THE LICENSING PROCESS AND THE APPROVAL OF CHANGES TO THE STRUCTURE?

In order to promote a sound financial system, it is necessary to define the group of institutions to be regulated and supervised. The licensing process plays a key role in setting up this process by regulating market access. Licensing should as a minimum consist of an assessment of the bank's ownership structure, its directors and senior management, its operating and business plans, its projected financial condition, and its internal control system. The assessment of an acquirer of shares in a bank is also an important precondition for a healthy financial system. A bank's major investments or acquisitions should also be considered, so that the supervisor has a good sense of the bank's group structure.

WHAT SHOULD BE EMBEDDED IN PRUDENTIAL REGULATIONS AND REQUIREMENTS?

Special attention is paid to basic prudential requirements in the Core Principles. They include the setting of minimum capital requirements for all banks, and an evaluation by supervisors of banks' policies, practices and procedures relating to risk management. In order to understand risks and be satisfied that banks are adequately identifying, measuring, managing and controlling risk, supervisors must themselves be skilled in risk management. Appropriate risk management systems for credit risk, country and transfer risks, market risk, interest rate risk, liquidity risk, legal risk and reputational risk are key elements of banking supervision, together with internal controls, separation of duties and other

corporate governance mechanisms.[18] Capital adequacy is viewed as the main bank indicator, and should reflect the risk undertaken by banks.

WHAT ARE THE METHODS OF ONGOING BANKING SUPERVISION?

Principles on the methods of ongoing banking supervision are focused mainly on the means needed to provide sound supervision. One of the key requirements is an organisational setting that includes both on-site and off-site supervision. Staff working in both of these types of supervision should have regular contact with bank management in order to obtain a thorough understanding of the institution's operations. Banking supervisors should also have adequate means to gather proper information for an independent validation of the bank on an individual and consolidated basis.

WHAT ARE THE INFORMATION REQUIREMENTS?

The information obtained should express a real and fair view of the bank's financial condition and profitability, recorded by each bank through adequate reporting, and built on consistent accounting policies and practices. The required information should be provided on a regular basis, and its accuracy should be verified periodically by either the supervisor or an external audit.

WHAT FORMAL POWERS SHOULD SUPERVISORS HAVE?

The principle on the formal powers of the supervisor focuses mainly on empowering the banking supervisor with adequate enforcement measures and instruments to impose corrective actions on banks that fail to meet prudential requirements, and when either the financial system as a whole or depositors' interests are threatened. This should include the power to revoke the bank's license or recommend its revocation.

WHAT IS MENTIONED ON COOPERATION BETWEEN SUPERVISORS?

The last principles require supervisors to practice global consolidated supervision over their internationally active banks and define the basic framework for cooperation between supervisors to include the establishment of contacts and information exchange, in order to ensure that the cross-border business of internationally active banks is adequately monitored.

WHAT ARE SOME OF THE IMPLEMENTATION CHALLENGES FACING SUPERVISORS?

The Core Principles define the minimum requirements for effective banking supervision, and may appear at first glance to be rather simple to implement. However, as the ROSC (Reports on the Observance of Standards and Codes) and the FSAP (Financial Sector Assessment Program) reports of the IMF and the World Bank testify, many countries in developed economies as well as emerging markets do not fully comply with them. On the one hand, the process of turning the principles into national legislation and the issuance of regulations can be

18 In the implementation of Basel II, the Basel Committee's new framework for capital adequacy, operational risk has been identified as an additional type of risk that was not included in the Core Principles. (See Chapter 2 for a definition and discussion of operational risk.)

subject to political obstacles as well as scepticism on the part of the banking sector. Banking supervisors also face challenges that may require substantive staff training measures. A successful implementation of the Core Principles will require overall:

- A competent and motivated body of professional supervisors;

- A banking law and regulatory framework that supports sound banking practices;

- A sound credit culture including reasonable lending practices and an adequate framework for risk management; and

- Adequate accounting, reporting and disclosure requirements that support financial transparency.

The Basel Committee's "Core Principles Methodology" will help supervisors implement the Core Principles. In addition to the Core Principles, the Basel Committee has issued a range of recommendations for banks relating to risk management. These recommendations can be downloaded from the Basel Committee's website (which is a subsection of the website of the Bank for International Settlements (BIS) in Basel, Switzerland (www.bis.org)). A list of risk management recommendations is included in sub-section 2.5 on risk-based supervision.

2.4 INTERNATIONAL BODIES AND FORA IN SUPERVISION AND FINANCIAL STABILITY

The conduct of banking supervision is complex and should be properly organised and managed at national level. The globalisation of banking markets poses significant challenges for supervisory cooperation and information-sharing across borders, and supervisors therefore need to build on mutual trust and understanding as well as confidentiality. For this purpose, global standards are needed in banking supervision as well as in other fields of finance.

WHICH BODIES AND FORA ISSUE SUCH GLOBAL STANDARDS?

The general guidelines, principles, recommendations, etc. that are published by international standard-setters – as these bodies and fora are often called – are not legally binding in any country; they represent the outcome of discussions between a team of professional experts in a specific field of the financial market, regulators/supervisors and representatives of market players. The main international standard-setters relating to financial markets are:

- The Basel Committee on Banking Supervision – its members, namely Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the UK and the US, are represented by their central bank and also by the authority with formal responsibility

for the prudential supervision of banking business where this is not the central bank. The Basel Committee formulates broad supervisory standards, guidelines and recommendations of sound practices in the expectation that national authorities will take steps to implement them through detailed arrangements – statutory or otherwise – which are best suited to their own national systems. Put another way, the Basel Committee seeks to improve financial stability through ensuring consistency of supervision, sound banking practices (qualitative standards) and minimum capital requirements (quantitative standards).

– The International Accounting Standards Board (IASB) – an independent, privately-funded accounting standard-setter based in London. The Board members originate from nine countries and have diverse functional backgrounds. The IASB is committed to developing, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require transparent and comparable information in general purpose financial statements (International Financial Reporting Standards (IFRS)). In addition, the IASB cooperates with national accounting standard-setters to achieve convergence in accounting standards around the world as well as with the Basel Committee, the European Commission and the ECB.

– The International Organization of Securities Commissions (IOSCO) – the leading international grouping of securities market regulators. Its current membership comprises regulatory bodies from more than 100 countries, which have day-to-day responsibility for securities regulation and the administration of securities laws.

– The Financial Action Task Force on Money Laundering (FATF) – an intergovernmental body established with the purpose of developing and promoting policies, both at national and international levels, to combat money laundering and terrorist financing. The Task Force is a policy-making body that aims to generate the necessary political will to bring about national legislative and regulatory reforms in these areas.

– The IMF/World Bank. The IMF is an international organisation of 184 member countries. It was established to promote international monetary cooperation, exchange rate stability, and orderly exchange rate arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease adjustments to balance of payment problems. The World Bank is a development bank that provides loans, policy advice, technical assistance and knowledge-sharing services to low and middle-income countries to help reduce poverty. The bank promotes growth to create jobs.

– The Financial Stability Forum (FSF) – a forum convened in April 1999 to promote international financial stability through information exchange and international cooperation in financial supervision and surveillance. The

FSF brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF seeks to coordinate the efforts of these various bodies in order to promote international financial stability, to improve the functioning of markets, and to reduce systemic risk. The FSF promotes a compendium of 12 Standards that lists the various economic and financial standards that are internationally accepted as important for sound, stable and well-functioning financial systems. The compendium includes the standards of the Basel Committee, the IASB, IOSCO and the FATF, as well as standards of other standard-setters. More information about the FSF and the compendium of 12 standards can be found on the FSF's website (www.fsforum.org).

The international standard-setter that has the most direct impact on banking regulation and supervision is the Basel Committee, although a key role is also played by the IASB because it issues the accounting standards that provide the basis for the financial statements of many banks. In this context it is worth mentioning that by 2006, EU banks have to shift to the IASB's IFRS. It should also be recalled that the IMF and World Bank use the standards of the Basel Committee as a benchmark to measure supervisory policies and practices in their FSAP, ROSC, and Financial Sector Stability Assessment (FSSA).

IS THERE AN EU-WIDE PROCESS THAT CATERS FOR REGULATION AND SUPERVISION?

There is no EU-wide standard-setter, but rather EU law in the form of Regulations that are directly applicable in EU Member States, Directives that need to be transposed into national law, and Recommendations that are not legally binding for Member States. The Commission proposes legislation that is approved in a co-decision procedure involving the European Committee of Finance Ministers (ECOFIN) and the European Parliament.

In the EU framework of Regulations and Directives, a procedure has been established known as the "Lamfalussy approach". This approach, which was originally developed for the securities sector, was born out of a proposal put forward by the Committee of Wise Men chaired by Baron Alexandre Lamfalussy. The aim was to simplify and speed up the complex and lengthy regular EU legislative process by means of a four-level approach. In December 2002, the European Council decided to extend the Lamfalussy approach to the entire EU financial sector.

According to the Lamfalussy approach, the EU institutions adopt framework legislation under the patronage of the EU Commission (Level One). The Commission prepares the detailed technical implementing measures with the help of four specialist committees (Level Two), namely the European Banking Committee (EBC), the European Securities Committee (ESC), the European Insurance and Occupational Pensions Committee (EIOPC) and the Financial

Conglomerates Committee (FCC) – the latter dealing with supervisory issues relating to cross-sector groups. These committees are composed of high-ranking representatives designated by the national finance ministries under the patronage of the Commission. They decide on implementing measures put forward by the Commission. The Commission may adopt these measures directly if a qualified majority of the members of the relevant specialist committees approve.

In developing these measures, the Commission is then advised by a series of committees of experts (Level Three). These are the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS). These committees are composed of high-ranking representatives from the national supervisory authorities. CEBS also includes representatives from the national central banks and the ECB. Apart from advising and assisting the Commission in the development of technical implementing measures, the Level Three committees of experts also deal with the exchange of supervisory information, the consistent implementation of European legal acts and the harmonisation of supervisory practices in the European market for financial services. In that sense, CEBS has a role to play both in regulation and supervision. This is also the case for the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB), which is outside the committee structure of the Lamfalussy approach. The BSC advises the ECB in connection with its function of offering Opinions on new Regulations and Directives. It also analyses financial stability and developments in banking structures in the EU.

Finally, the Commission – in close cooperation with the Member States, the regulatory authorities involved in Level Three and the private sector – checks that Community law is applied consistently (Level Four).

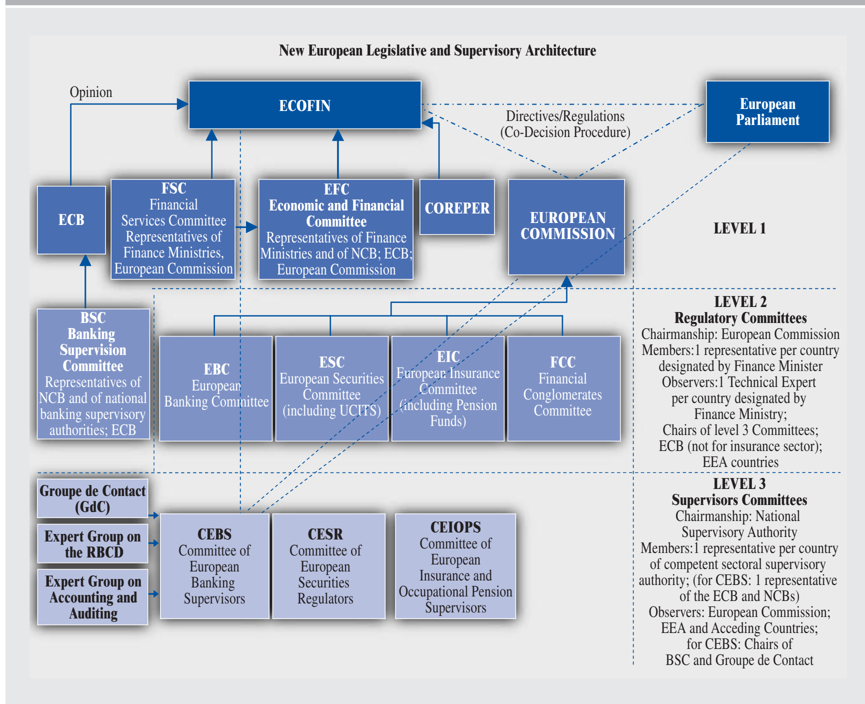
Diagram 2.1 illustrates the committee structure under the Lamfalussy approach and also includes the role of the BSC and the ECB.

The Lamfalussy approach is described in more detail in the article "Developments in the EU framework for financial regulation, supervision and stability" published in the November 2004 ECB Monthly Bulletin. The publication is available on the ECB's website.

2.5 COMPLIANCE-BASED AND RISK-BASED SUPERVISION

The banking business constantly changes, incorporating new technologies that have an impact on the speed of transactions and lead to increasingly interconnected markets. New financial instruments and products are constantly being developed and offered. In particular, banking is increasingly moving

Diagram 2.1 New European Legislative and Supervisory Architecture

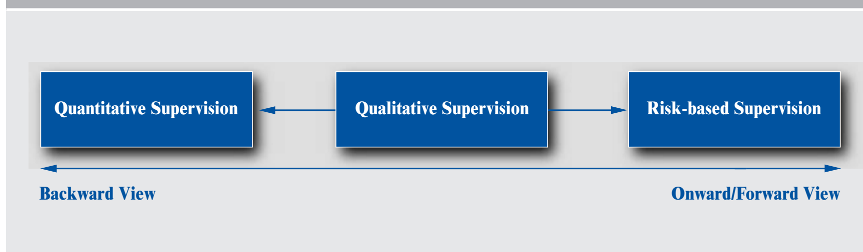


towards electronic banking (e-banking), with automated processes for processing large volumes of transactions of any size. Traditional banking risks such as credit risk, liquidity risk and market risk are thereby increasing, which continues to create new challenges for supervision. Given the speed of such developments, risk-based supervision is therefore seen as a necessary supplement to compliance-based supervision. Banking regulations alone cannot incorporate all aspects of the modern banking business. The quantitative scope of banking regulation must be enhanced by qualitative aspects and a preventive risk-based focus. Focusing on all these aspects is equally important and none of them should be forgotten or, on the contrary, be privileged above the others.

WHAT IS COMPLIANCE-BASED SUPERVISION?

Compliance-based supervision is a process whereby the banking supervisor, as the controller, checks that banks comply with rules and regulations. Rules and regulations can be quantitative and qualitative, which means that compliance-based supervision includes quantitative as well as qualitative supervision elements.

Diagram 2.2 Time aspect of types of banking supervision



One way to illustrate the interplay between these types of supervision is shown in diagram 2.2.

WHAT IS QUANTITATIVE REGULATION AND SUPERVISION?

Quantitative regulation and supervision is a form of supervision that relies on quantitatively measurable data. It is in principle the only type of supervision that has an objective nature: either the bank fulfils the minimum capital requirement of holding 8% capital against risk-weighted assets, or it does not and action needs to be taken by the supervisor. Many rules and provisions issued by the banking supervisor are based on quantitative indicators such as capital requirements, liquidity, large exposures, foreign exchange positions and limits, and provisioning requirements. Quantitative supervision allows supervisors to compare banks' performance and their ability to withstand shocks. Through assumptions in measurement banks can influence quantitative data, and where there is such scope for variation, supervisory attention is required. Quantitative supervision offers the following advantages:

– Accuracy, which allows the supervisor to monitor the bank against clear limits or benchmarks;

– Objectivity in terms of the chosen approach, which provides the supervisor with clearly objective information as a basis for decision-making; and

– Comparability across the banking sector, which allows the supervisor to conduct peer group analysis, whereby weak banks are identified and supervisory resources directed to address problems in these banks.

However, a major drawback of the approach is that it is backward-looking. Statistical quantitative analysis enables the supervisor to project the development of quantitative data, but such analysis is always based on backward-looking information and data. Quantitative regulations do not allow the supervisor to act in a preventive manner because such regulations do not permit the supervisor to impose corrective measures on a bank that is approaching a breach of its limits. In fact, the supervisor always risks being informed too late with little or no possibility to respond, as the data is received, the limits have already

been breached. This situation can be avoided if the supervisor is mandated to exercise supervisory forbearance, whereby the bank is permitted to breach its limits for a given period of time, during which the bank, in close cooperation with the supervisor, must work out a plan that, when implemented, will improve its situation.

The quantitative type of regulation and supervision is therefore seen as insufficient for the supervisor to fulfil its mandate. The supervisor must therefore identify the reasons behind the quantitative shortcomings that have impacted the bank's financial position. The analysis of the quantitative aspect therefore has to be complemented by analysis of qualitative factors.

WHAT ARE QUALITATIVE REGULATION AND SUPERVISION?

Qualitative regulation and supervision are forms of supervision that are focused on the assessment of qualitative aspects relating to the bank and its business policies that directly or indirectly can influence its performance. Qualitative aspects and requirements are difficult to define precisely; they can vary across institutions and therefore tend to take a relative instead of a normative nature. General qualitative requirements are usually set out by the supervisor which, during a monitoring process and inspections, assesses whether the bank is complying with them. This assessment should be based on the professional judgement of the supervisor without being influenced by the bank or a third party. Quantitative supervision looks at the appropriateness of:

- the bank's organisational structures;
- procedures for board and senior management oversight;
- existing procedures, and whether they are well-documented;
- internal and external (by the public and supervisors) transparency;
- the skills of management and staff;
- internal control mechanisms, including separation of duties;
- internal as well as external audit; and
- the quality of accounting procedures.

Because qualitative aspects depend on the supervisor's subjective assessment, and hence could be open to dispute with the bank, it can be difficult for the supervisor to enforce the qualitative regulation. In any case, the supervisor should have a range of tools and instruments at hand that allow the supervisor to convince or require a bank to improve qualitative aspects of its business.

Box 2.1 Evaluation of Internal Control Systems by Supervisory Authorities

Supervisors should require that all banks, regardless of size, have an effective system of internal controls that is consistent with the nature, complexity and risk inherent in their on and off-balance-sheet activities, and which responds to changes in the bank's environment and conditions.

In those instances where supervisors determine that a bank's internal control system is not adequate or effective for that bank's specific risk profile (for example, it does not cover all of the principles contained in this document), they should take appropriate action.

The Basel Committee's Core Principles are supplemented by recommendations and guidelines that can form the basis for qualitative regulations and supervision. One such example is the paper "Framework for Internal Control Systems in Banking Organisations" from September 1998 (see Box 2.1).

WHAT IS RISK-BASED SUPERVISION?

The role of banking supervision is becoming increasingly preventive with the aim of ensuring that banks' operations are safe and sound. It is not sufficient for banking supervisors to rely on quantitative and qualitative compliance of banks; they need to be sure that banks are capable of avoiding taking on substantive risks in the future, and to cover potential damages caused by these risks if they occur.

Historically, bank examinations relied primarily on procedures to test individual transactions in order to assess banks' condition, internal policies, procedures and controls. In today's highly dynamic banking market, however, transaction testing by itself is not seen as sufficient for ensuring that banks' operations remain safe and sound. Hence, banking supervisors place increasing emphasis on knowing the risks faced by the individual bank and feeling comfortable that the bank has in place the processes necessary to identify, measure, manage and control risk exposures. This is the main objective of the risk-based supervision approach.

Under the risk-based supervisory approach, risk management is the key area monitored by the banking supervisor. Adequate risk management programmes can vary considerably in sophistication, depending on the size and complexity of the bank and the level of risks that it bears. Small institutions engaged solely in traditional banking activities, where senior managers and directors are actively involved in day-to-day operations, may rely on basic risk management systems as adequate. Large, multinational banks and financial conglomerates, on the other hand, need to have far more elaborated, well-developed and formal risk management systems to cover their broader and typically more complex range of financial activities. The monitoring and management information system, which

provides senior managers and directors with adequate data for the decision-making process, should enable them to identify and properly assess the risk position of the bank.

Risk-based supervision is arguably qualitative in nature and is therefore covered in the above description of compliance-based supervision. The compliance-based and the risk-based approaches overlap to some extent, but differ in that the core emphasis of the supervisor changes from checking formal requirements with mostly quantitative regulations to examining qualitative regulations, with particular focus on risk management procedures. The latter can, in combination with supervisory information on present risk exposures, allow the supervisor to assess whether the bank will also remain compliant; the supervisor hereby assesses whether the bank's management is acting prudently in terms of the bank's processes and procedures to ensure its existence in the future. A couple of examples of the benefits of taking a risk-based approach include the following:

– It permits the supervisor to assess a bank's risk profile and the potential risks a bank may face in the future, thereby taking an ongoing as well as a forward-looking perspective on the likelihood of future compliance;

– It provides broader recognition of the importance of the quality of bank management and the quality of internal procedures, thereby allowing the banking supervisor to react to problems in a timely manner with recommendations or corrective action; and

– It reduces the supervisory burden, because undertaking a full-scale transaction testing of banks for compliance is impractical and in any case is the responsibility of bank management.

WHAT ARE THE KEY ELEMENTS OF A SUPERVISOR'S RISK MANAGEMENT ASSESSMENT?

When assessing the quality of a bank's risk management, the banking supervisor ensures that the following conditions are met:

– The bank's risk monitoring practices and reports address all of its material risks;

– Key assumptions, data sources and procedures used for identifying, measuring, monitoring and controlling risks are appropriate and adequately documented and tested for reliability; and

– Reports are consistent with a bank's activity and are structured to monitor exposures in accordance with limits, goals and objectives set up.

In relation to the role of bank management, the supervisor assesses that:

- Reports to management and a bank's directors are timely and accurate and contain sufficient information supporting adequate decision-making processes;

- The board and senior management have a clear understanding and working knowledge of the risks relevant to the bank's activity;

- The board and the management have reviewed and approved appropriate procedures to limit risk exposures in lending, investing, trading, trust and fiduciary services and other significant activities or products;

- The Board periodically reviews and adjusts risk exposure limits;

- The management ensures the banking business is conducted by professional and experienced staff;

- The management adequately controls the day-to-day activity of the bank and is able to recognise risks arising from changes on the market; and

- The management identifies reviews and tests all risks related to new activities and products before their launch.

The supervisor also looks at issues in relation to internal controls and financial reporting. These include the following:

- A bank should have procedures in place defining clear authority and responsibilities for each particular type of a bank's activity, and these procedures should be reflected in the organisational structure of the bank;

- The system of internal controls should be appropriate to a bank's risk profile;

- Reporting lines must be independent from business lines;

- There are adequate procedures within a bank that ensure compliance with applicable law, regulations and valid provisions;

- Internal audit is independent and objective;

- Internal controls and information systems have been adequately reviewed and tested; and

- Financial, operational and regulatory reports are reliable, accurate and timely, and mistakes are noted and promptly investigated.

The above three groups of risk management issues illustrate that the supervisor in the risk-based supervision approach requires bank management to place increasing emphasis on procedures and in-house control functions that will enable the bank to remain sound, prudent and continue to operate for the benefit of the bank's depositors, its creditors and financial stability.

3 LICENSING OF BANKS

Licensing is a process designed to regulate market access. As mentioned in previous chapters, banks are important for the functioning of a market economy and rely crucially on the trust of citizens in their operation. To allow citizens to feel comfortable that a bank is actually what it portrays to be, the use of the word "bank" is restricted in the financial sector (with a few exceptions for compound ideas, such as *data bank*) by the requirement that banks must obtain a license from the banking supervisor, which after issuing the license checks the bank's compliance with the rules and regulations on an ongoing basis. Once the management of a bank in the EU has received a license, the bank has the privilege to solicit deposits from the general public. The licensing process is important and should be addressed accordingly by the supervisor, as actions by the supervisor to withdraw a license are very complex and potentially carry reputational risks for the supervisor as well as for the whole financial system. Additional information in relation to such difficulties is included in Chapter 5 on crisis management and bank rehabilitation.

This chapter describes the international principles and EU rules for licensing of banks, and looks specifically at fit and proper tests of management, assessment of shareholders and the ownership structure, business plan evaluation and cooperation between home and host country supervisors.

After reading this chapter, the reader should understand what supervisors should be examining in the licensing process and that they should continue to monitor all of those issues afterwards.

WHAT ARE THE INTERNATIONAL PRINCIPLES AND EU RULES IN TERMS OF LICENSING REQUIREMENTS?

The Basel Committee's Core Principles for Effective Banking Supervision, numbers 2 to 5, relate to the licensing process and read as follows:

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 establishment that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation'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.

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.

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 an EU context, the Basel Committee principles relating to licensing have been transposed into Articles 4 to 17 of the EU Directive (2000/12/EC) relating to the taking up and pursuit of the business of credit institutions. The term "credit institution" is synonymous with what is understood to be a bank in the EU. The EU directive has been transposed by each EU Member State into its own national banking law. This transposition can give rise to national differences in banking laws, as the Directive only sets out the minimum requirements. The minimum harmonisation achieved through the EU allows licensed credit institutions to operate across borders within the Union, as the competent authorities in the different Member States have agreed on the mutual recognition of institutions licensed in one Member State and the supervisory regime that they are subject to in the licensing Member State. The full text of the Directive is included as an annex to this textbook. The main elements of the Directive are as follows:

– The credit institution must obtain a license before commencing activities (Article 4);

– Separate own funds or initial capital shall be no less than €5 million with some exception for special institutions (Article 5.1);

– The credit institution shall have at least two persons who effectively direct the business, who must be of sufficiently good repute and have sufficient experience to perform such duties (Article 6.1);

– The competent authority must have been informed of the identities of shareholders or members that have qualifying holdings and the amount of such holdings (Article 7.1), and the authority is satisfied as to the suitability of these shareholders or members (Article 7.2);

– Close links between the credit institution and other natural or legal persons do not prevent the effective exercise of the supervisory function (Article 7.3);

– Application for a licence is accompanied by a programme of operations setting out, inter alia, the types of business envisaged and the structural organisation of the institution (Article 8);

– Member States may not require the application for authorisation to be examined in terms of the economic needs of the market (Article 9);

- Refusal to grant a license shall be given within six months from receipt of information required for the decision (Article 10);

- The European Commission shall be notified of all authorisations and keep an updated list of licensed credit institutions in the EU which shall be published (Article 11);

- The authority shall consult competent authorities in other Member States if the license is being issued to a) a subsidiary of a credit institution authorised in another Member State; or b) a subsidiary of a parent undertaking of a credit institution authorised in another Member State; or c) controlled by the same persons, where natural or legal, that control the credit institution authorised in another Member State (Article 12);

- Host Member States may not require authorisation or endowment capital for branches of credit institutions authorised in other Member States (Article 13);

- Authorities may withdraw licenses if they have not been used within 12 months; if obtained on false information; if the institution no longer fulfils the conditions under which the license was granted, etc. (Article 14);

- Institutions can in principle use the same name (i.e. bank, savings bank) throughout the EU (Article 15);

- The competent authority shall be informed by acquirers if they intend to hold more than 20, 33 or 50% in a credit institution. If they oppose to such acquisition, the competent authority shall inform the acquirer within three months (Article 16.1); and

- Every credit institution should have sound administrative and accounting procedures and adequate internal controls (Article 17).

WHAT IS THE SUPERVISOR LOOKING FOR IN THE LICENSING PROCESS?

Naturally, all the above points from the EU Directive are important and should be reviewed and monitored on an ongoing basis. The following section addresses some key aspects, namely the issues of the evaluation of a fit and proper nature of management, the assessment of shareholders, the business plan, and the cooperation between home and host country supervisors.

3.1 FIT AND PROPER TESTS OF BOARD OF DIRECTORS AND SENIOR MANAGEMENT

Fit and proper tests of board of directors and senior management are among the most important safeguards regarding the safety and soundness of any bank or banking system, as the board and management of a bank represents the first line of defence of any bank (see Chapter 2 on the importance of regulating and supervising banks in a market economy, which refers to the three lines of

defence in banking). The tests allow the supervisor to block participation in the banking system by actors whose past actions have revealed mismanagement, fraud and inappropriate self-dealing. The evaluation centres on three aspects:

– Competence

– Integrity

– Qualifications.

In terms of competence, the supervisor aims to assess whether board members and managers have adequate experience to lead a bank. This experience can for instance take the form of having held equivalent positions for a certain period in the banking sector or another comparable qualifying experience. The focus is usually on documented length of relevant experience.

With regard to integrity, the supervisor checks for any criminal charges and tries to establish whether board members and managers are likely to adhere to moral standards and ethics. The supervisor can conduct background checks on whether previous activities, including regulatory or judicial judgements, raise any doubts concerning the proposed person's ability to make sound judgements in an honest fashion. During such checks the supervisor may for instance contact enforcement agencies, the tax authority, the police and the patent and registration office as well as national courts. The absence of any critical findings is considered to be positive and is seen as a signal that moral standards and ethics will be adhered to in the future as well.

In terms of qualifications, the supervisor looks at the formal qualifications/education of the proposed board memb ers and managers. The supervisor will commonly review their curricula vitae.

In addition to the "fit and proper" test, another issue to be examined in relation to board and management is that there must be a sufficient number of members in relation to the intended scope of the business activities and their complexity. For reasons of corporate governance, the proposed management structure must show a balance between executive/non-executive directors to secure checks and balances that – if missing – could allow them to pursue their own narrow interests for personal advantage, thereby disregarding the rightful claims of shareholders and other stakeholders. Within this group of individuals there must be a clear allocation of responsibilities, and an organisational structure that prevents conflicts of interest from arising.

In Germany for example, the Banking Act requires that senior managers must have adequate theoretical and practical knowledge of the business of the bank, they must be trustworthy, and they must have sufficient managerial experience. A potential manager is under normal circumstances assumed to have the

professional qualifications necessary for managing an institution if he or she has a university degree and can demonstrate three years of managerial experience at an institution of comparable size and type of business. In addition, checks will be performed on the trustworthiness of the proprietors and managers by consulting a federal database; written confirmation will be sought from a credit institution that the own funds of the institution seeking a license have been paid in; a viable business plan must be presented; and association with other entities through corporate ties must not impair the effective supervision of the institution.

3.2 ASSESSMENT OF SHAREHOLDERS AND THE OWNERSHIP STRUCTURE

The primary objective is to obtain clear and unambiguous information about the true owners of the bank, and the supervisor should not tolerate any lack of clarity in this connection. Shareholders that try to hide behind complex ownership structures always send a signal that their intentions are not pure and that the bank is being created for a purpose that does not match the obligation of the supervisor to protect the public interest, depositors and the stability of the financial system. When this information has been obtained, the process of assessment is in some ways similar to the fit and proper assessment of management. More specifically, the supervisor should assess the following:

- The business intentions of the shareholders in establishing the bank: these must be judged to be sound;

- The track record of shareholders on past business ventures, and in particular whether there have been failures (and if so, the cause of these);

- The integrity of the shareholder in the business community;

- The source of the capital invested: the supervisor should evaluate whether the shareholders are investing their own money with a long-term perspective. The shareholders should be willing to trust the business plan and policies of the bank;

- The ability of the shareholders to provide additional funds, if needed. This implies an analysis of the financial strength of the shareholders;

- The linkages with other investments of the shareholders, which in essence relates to the shareholders' fit and proper nature. Complex investment structures that for instance include other banks which would not be subject to consolidated supervision could hinder effective supervision; and

- The relationship between shareholders and managers and the distribution of roles between the two groups, to ensure that checks and balances are observed.

3.3 BUSINESS PLAN EVALUATION

In evaluating the business plan, the supervisor assesses what the mission and vision of the bank is; what their plan is; and whether they have tried to make a thorough assessment of the market that they are entering – and understood the market conditions. The idea is not for the supervisor to assess whether there is a market need for the bank, but that the bank (shareholders and management) has understood the business endeavour that is being undertaken and that this is consistent with the proposed organisation and set-up that the bank is proposing. As such, the business plan must from a supervisory perspective include:

- A clearly stated vision and mission for the bank, identifying the specific market, product and services;

- A market analysis that assesses the market in which the bank expects to draw the majority of its business, and which includes a strategy for the bank's ongoing operation. This could for instance include the bank's assessment of its effective competitive advantages, the core competencies it has as well as needs to develop, its strengths, weaknesses, opportunities and threats (SWOT), and its assumptions made in the market analysis; and

- A strategy, and how the bank intends to attain it in operational terms. In this context, the supervisor may for instance wish to see whether the bank has properly assessed the market space that it intends to enter; whether there is sufficient space for the bank; and the prospects for the bank to survive in this market.

Turning to issues that are mostly internal for the bank, the business plan should also include:

- A proposal for the bank's internal organisation, which should be consistent with the proposed strategy. In this context, the supervisory focus is typically on whether the bank has developed corporate values, adequate internal policies and procedures with sufficient resources, including appropriate corporate governance structures such as i) a management structure with clear accountability, clearly defined responsibility duties and authorities of the board and senior management ii) a board of directors with the ability to provide an independent check on management through an effective reporting to the board and iii) independent audit and compliance functions. It is also important that the so-called four-eyes principle is followed, which implies inter alia a segregation of various functions, cross-checking, dual control of assets and double signatures;

- The establishment of an independent internal audit function with proper documentation and sufficient resources and appropriate skills;

- Compliance with laws, rules and regulations;

- The choice of the external auditor;

- Planned management information systems and IT systems in general that are suitable for the bank's operation and allow the institution to provide prudential/supervisory returns and reports on a timely basis;

- Planned internal controls with experienced staff and systems covering all activities and functions of the bank;

- The planned procedures, processes and systems for the identification, measurement, management and control of banking risks;

- A plan for the development of the bank's capital base, including an assessment of whether it can comply with the minimum requirements in terms of both tier 1 and tier 2 capital, and whether it is adequate for the planned operations; and

- Financial projections that are realistic and consistent, with the aim of assessing the sufficiency of capital, the ability of the shareholders to provide additional financial support, and the financial condition of the corporate parent.

As an example, the Dutch banking supervisor requires banks to present realistic and consistent financial projections for the balance sheet and the profit and loss account for the first three years of operation.

3.4 HOME AND HOST COUNTRY COOPERATION

Finally, as mentioned in the Basel Core Principles and in the EU Directive, approval of a banking license to open a branch or a subsidiary by a bank from a foreign jurisdiction triggers the need for cooperation between the host supervisor considering the application for a license, and the home country supervisor where the parent undertaking is licensed. In principle, the host country supervisor should not approve the license before having obtained the consent of the home country supervisor. In addition, the host country supervisor should consider whether the home country supervisor performs its supervisory tasks in a capable manner, including on a consolidated basis. In this context, consideration should be given to the nature and scope of the home country supervisory regime, as well as whether the organisational structure of the applicant or its group allow for effective supervision by both the home and the host supervisor. It is becoming increasingly common that home and host supervisors conclude Memoranda of Understanding relating to their cooperation. These can take the form of general Memoranda of Understanding or specific ones relating to particular institutions.

4 OFF-SITE AND ON-SITE BANKING SUPERVISION

On-site and off-site supervision are two sides of one coin: they supplement each other, and would not be complete without each other. This is acknowledged in the Basel Committee's Core Principles, which prescribe that both off-site monitoring and on-site inspections represent the preconditions for effective supervision.

This chapter first describes the functions of off-site monitoring, the qualitative aspects considered and the systems and tools that can assist supervisors in identifying weak banks where additional supervisory attention is required. The chapter then describes on-site inspections and how they are planned and carried out in some EU countries. Finally, the new capital framework (Basel II) as agreed by the Basel Committee is described. In addition to setting minimum capital requirements, Basel II foresees a supervisory review process as well as disclosures to allow market discipline to support the supervisory process.

After reading this chapter, the reader should understand:

– the role of off-site and on-site supervision, and how they complement each other;

– the tools available in both processes; and

– the principles of the Basel II framework.

4.1 OFF-SITE SUPERVISION

WHAT ARE THE MAIN OBJECTIVES OF OFF-SITE SUPERVISION?

Off-site supervision has three main objectives:

– To monitor the development and levels of risk at individual banks and in an benchmarking exercise, comparing the bank with a peer group of comparable institutions;

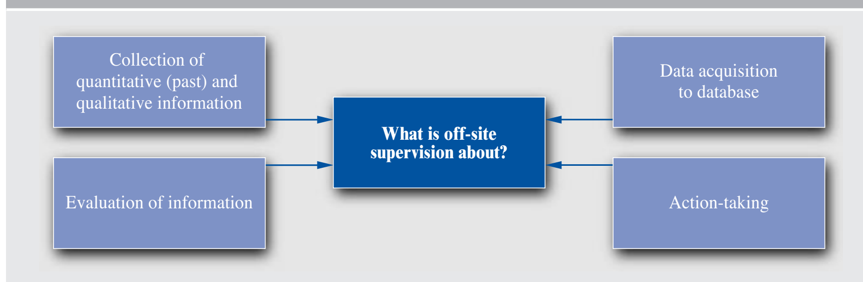
– To monitor a bank's compliance with prudential limits; and

– To provide input for the prioritisation of supervisory resources and for planning of inspections.

WHAT ARE THE GENERAL ASPECTS OF OFF-SITE SUPERVISION?

The off-site supervision process starts with the collection of mostly quantitative information that can provide the supervisor with information about the past and current standing of the bank. The supervisor can store the collected data in a database so that the information can be automatically evaluated. The overall

Diagram 4.1 General aspects of off-site supervision



purpose is to assess whether there is a need for supervisory action. These general aspects of supervision are reflected in Diagram 4.1.

The work of the supervisor in relation to information collection and use has four principal phases:

1. Collection of data/information and storage in a database;

2. Calculation of ratios and limits to check for compliance with existing rules and regulations and to assess normative developments;

3. Comparison of an individual bank with its peer group to assess relative developments and to prioritise supervisory resources for efficient use on the banks that are weaker in relative terms; and

4. Advanced structural analysis, using quantitative methods such as scenario analysis, stress testing, and so-called early warning systems, to try to predict whether the bank will be profitable and comply with requirements in the future as well.[19] When the analysis is forward-looking, it increasingly allows the supervisor to take timely decisions, although it builds on historical data that reflect past performance.

WHAT SHOULD THE SUPERVISOR CONSIDER IN TERMS OF COLLECTION OF DATA?

Supervisors must have adequate means to collect proper and sufficient information on banks on an individual and on a consolidated basis. Issues generally covered in supervisory reporting by banks include:

- Capital adequacy (composition and quality of capital, adequacy, access to capital, repayment of capital);

19 These types of analysis can be performed on individual banks, a group of banks or on the whole banking system. In the latter case, the analysis would typically be characterised as macro-prudential analysis and be part of a framework for financial stability monitoring. See Chapter 7 of this book for more information about these types of analysis.

- Liquidity (liquid assets, access to market, the liquidity plan);
- Asset quality (composition, concentration, provisioning);
- Liability (composition and concentration);
- Earnings (profitability, earning performance, the profit plan and budget);
- Risk concentration (key products and markets, market risks, risk positions);
- Management (fit and proper nature, board composition, cultural attitude, corporate planning and strategy); and
- Internal control system (decision-making process, risk management framework, limits and standards, IT, reporting, staff policy, segregation of responsibilities, money laundering controls).

The above list consists of both quantitative and qualitative elements which require different means of reporting and storage. Some elements are reported on a quarterly basis directly to the supervisor, while other elements are reported on a quarterly or annual basis, or when changes have occurred. If needed, the supervisor can request special reports with additional details to look at for instance particular exposures, risks or off-balance sheet activities. The structure of regular reporting to supervisors is at the discretion of individual EU supervisors, leading to an increased reporting burden for banks that operate in several EU countries. As described in Chapter 2 on regulating and supervising banks, a committee set up under the Lamfalussy approach is entrusted with the task of achieving convergence with regard to such differences.

In addition to information reported directly to the supervisor, additional and valuable information can be found in correspondence with the bank, formal and informal communications, and requests for approval of acquisitions or disposals, appointment of directors/managers, changes in the structure of shareholders, etc. Regular meetings with management can be another valuable source of information. Other useful sources include publicly available information such as quarterly, semi-annual and annual financial statements and reports. Annual reports have the particular advantage of having been audited, and the supervisor should have access to the auditor's reports relating to the statutory accounts and the auditor's opinions regarding these statements, as well as correspondence between management and the auditor. If the auditor produces a special report on topics requested by management, these should also be available. In general, the supervisor should closely cooperate with the external as well as the internal auditor. In some EU countries the auditor undertakes many tasks in the off-site supervision process.

How supervisory reporting is transmitted in practice depends on both the technical level of systems operated in the banking system and on the technical capacities of the supervisor. Electronic data processing is only possible when the banks and the supervisor are capable of handling data electronically. Although data can be submitted in paper form, there are substantial advantages to electronic submission. However, before electronic signature certificates are fully operational there might be a legal need for particular qualitative information to be submitted purely in paper form.

WHICH RATIOS AND LIMITS ARE TYPICALLY REPORTED OR CALCULATED IN THE EU?

The basic tool applied by supervisors to analyse collected data is ratio analysis. Ratio analysis enables checking of banks' compliance with limits, and additionally permits individual banks to be compared with a peer group of comparable institutions. Specific ratios often set out particular requirements in prudential regulation, such as for example the capital adequacy ratio or the liquidity ratio. Ratios also provide a good starting point for understanding the financial statements of a bank. Ratios are used to describe for instance banks' profitability, efficiency, credit risk exposure, capital, income distribution, dynamics (growth or decline), balance sheet structure and margins. The tables below lists ratios that are used in many EU countries.

Table 4.1 Ratios used to assess performance-related issues

Issue	Ratio	Definition
Profitability	Return on equity (ROE)	Net profit/equity
	Return on assets (ROA)	Net profit/total assets
	Net interest margin	Net interest income/total interest-bearing assets
	Operating income/total assets	Operating income (excluding provisions)/total assets
Efficiency	Cost-to-income Ratio	Operating costs/operating income
	Cost-to-asset Ratio	Operating costs/total assets
	Staff costs to total income	Staff costs/total income
Income breakdown	Interest income to total income	Interest income/total income
	Fee income to total income	Fee income/total income
	Trading income to total income	Trading income/total income
	Non-interest income to total income	Non-interest income/total income
Margins	Net interest margin	Net interest income/average assets
	Fee income margin	Fee income/average assets
	Trading margin	Trading income/average assets

Table 4.1 Ratios used to assess performance-related issues (cont'd)

Issue	Ratio	Definition
Margins	Income margin	Sum of interest, fee and trading income/average assets
	Operating cost margin	(Personnel expenses plus other administrative expenses)/ average assets
	Operating result margin	(Total income-operating costs)/ average assets
	Risk provision margin	Provision expenses/average assets
	Pre-tax profit margin	Pre-tax profit/ average assets

Table 4.2 Ratios used to assess risks, buffers and structure

Issue	Ratio	Definition
Credit risk	Risk provisions to total customer loans	Risk provision expenses/gross customer loans
	Risk provisions to risk-weighted assets	Risk provision expenses/total risk-weighted assets
	Risk provisions to net interest income	Risk provision expenses/net interest income
	Non-performing loans to customer loans	Non-performing loans/customer loans
	Coverage	Provisions/customer loans
	Risk-weighted assets to total assets	Risk weighted assets/total assets
Capital	Tier 1 ratio	Tier 1 capital/risk-weighted assets
	Total capital ratio	Total capital/risk-weighted assets
	Equity ratio	Equity/total assets
Balance sheet structure	Customer loans to total loans	Customer loans/total loans
	Interest-earning assets to total assets	Interest-earning assets/total assets
	Trading assets to total assets	Trading assets/total assets
	Deposits to total assets	Deposits/total assets
	Loan deposit ratio	Loan/deposits
	Interbank ratio	Interbank loans/interbank deposits
	Liquidity ratio	Liquid assets/short-term liabilities

Table 4.3	Ratios for assessment of growth	
Issue	**Ratio**	**Definition**
Growth	Change in customer loans	(Customer loans$_{t+1}$ –customer loans$_t$)/customer loans$_t$ *100
	Change in customer deposits	(Customer deposits$_{t+1}$ –customer deposits$_{t)}$ / customer deposits$_t$ *100
	Change in total assets	(Total assets$_{t+1}$ –total assets$_t$)/ total assets$_t$ *100
	Change in pre-provision operating profit	(Pre-provision operating profit$_{t+1}$ –Pre-provision operating profit$_t$)/Pre-provision operating profit$_t$ *100
	Change in pre-tax profit	(Pre-tax profit$_{t+1}$ –Pre-tax profit$_t$)/Pre-tax profit$_t$ *100
	Change in net profit	(Net profit$_{t+1}$ – net profit$_t$)/ net profit$_t$ *100

WHICH ANALYTICAL METHODS CAN BE USED IN OFF-SITE SUPERVISION?

There are several analytical methods for the assessment of banks in off-site supervision, of which two main ones can be identified:

– *A simple approach* for observing and analysing indicators or ratios for the balance sheet, income statement, and others in order to identify any possible deterioration of a bank's position in normative terms or relative to competitors; and

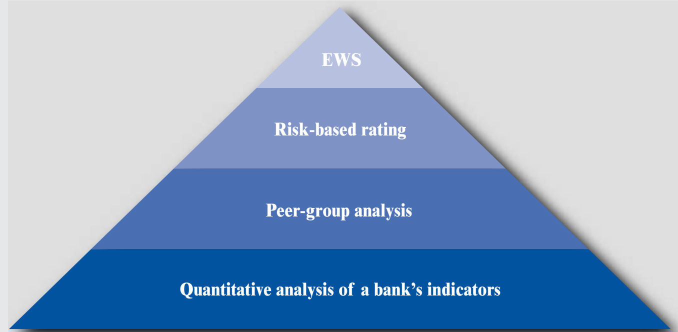
– *An advanced approach* using statistical econometric analysis, perhaps combined with additional qualitative indicators enabling the probability of default of a bank to be estimated or a rating to be given.

The simple approach is included at the bottom of the pyramid displayed in Diagram 4.2. The level of sophistication in approaches increases towards the top of the pyramid. How close to the top of the pyramid the supervisor is able to come depends on the availability and quality of data. Moreover, even if data are available, the supervisor may choose to remain at the bottom of the pyramid because of the cost involved in reaching the top. The national banking system in question may also have a structure that does not justify the use of the most advanced and sophisticated systems for off-site supervision.

WHAT ARE THE FEATURES OF THE ADVANCED MODELS FOR OFF-SITE SUPERVISION?

In the risk-based rating method, the supervisor uses qualitative and quantitative information to assign a rating that tries to predict the bank's ability to meet future obligations. The early warning systems (EWS) at the very top of the

Diagram 4.2 The pyramid of increasing sophistication in models for off-site supervision



pyramid have many similarities with risk-based ratings, but differ in that they typically try to calculate a probability of default.

Econometric models are used to provide supervisors with an early warning of the banks that are most likely to develop serious problems in the future. These models use the information provided about the condition of banks in their financial statements to derive a number that, in most cases, is the probability of default.

Statistical models used for off-site analysis try to find explanatory variables that provide a sound and reliable forecast of any deterioration in a bank's situation. Within the statistical field, various models are used in off-site supervision. The logit models are the current standard among off-site analysis models because their results can be interpreted directly as default probabilities. The weakness of these models is that they cannot take into account the point at which a bank's default can occur; however, this weakness can be compensated for by the Cox model, which also covers the time aspect.

An essential precondition for the application of statistical econometric models is the availability of a sufficient pool of data with high quality. It is often necessary to combine data from several sources, such as banks' direct reports to supervisors, banks' reporting to credit registers, and time series of macroeconomic indicators. Data compatibility is another important question to keep in mind. In short, the data requirements to reach the higher end of the analysis pyramid can be summarised as:

– sufficient data availability;

– data accuracy;

– sufficient time series;

– comparability and compatibility of data; and

– strong IT support.

The availability of such data will allow the supervisor to use advanced methods to obtain an objective assessment with a focus on the risks relating to an individual institution.

Many models, in particular risk-based ratings, tend to be built around the evaluation of five key components, which have been abbreviated to produce the so-called CAMEL model. This model addresses respectively:

Capital and its adequacy
Assets quality
Management
Earnings
Liquidity.

This model has been slightly refined in recent years to include analysis of the sensitivity of the bank to market risks and in relation to each of the five elements considered which means that the CAMEL model has now been renamed the CAMELs model.

To broaden the off-site supervision models further, additional elements are taken into account to look at the whole banking sector and its ability to withstand shocks in an aggregated manner. Such analysis is typically labelled macro-prudential analysis and is described in Chapter 7 on financial stability monitoring.

4.2 ON-SITE SUPERVISION

Off-site supervision and on-site supervision are complementary in the sense that off-site supervision is best suited to address quantitative elements of supervisory analysis, whereas on-site supervision is better suited for the qualitative elements. Without assessment of qualitative elements such as management strength and procedures and systems for risk management it would be difficult for the supervisor to move to a system that combines compliance-based supervision with the risk-based approach. For a definition and discussion of compliance-based and risk-based supervision, the reader is referred to Chapter 2 on regulating and supervising banks.

Off-site and on-site supervision do not make sense on their own, but this does not imply that staff engaged in the supervision of a bank must necessarily be involved in both off-site and on-site routines. The decisive condition is that

the two processes are intertwined and that there is a free flow of information in the two processes. Deciding on how often an on-site supervisor should inspect a bank depends on several factors: supervisory resources may play a part, but the burden that such visits place on the bank also has to be taken into consideration.

WHAT ARE THE MAIN OBJECTIVES OF ON-SITE SUPERVISION?

On-site inspections have two primary objectives:

- To allow the supervisor to understand better the business and risks of an individual bank, its risk profile and how qualified its management and staff are; and

- To obtain the assurance that the regulatory framework is being implemented correctly and that banks are managed and organised in a proper and sound way, including the risk management framework.

On-site supervision increases the scope of supervision and improves the interpretation of reports and other information submitted by banks to the supervisor. The supervisor can substantially benefit from the close contacts between the supervisor and bank staff during on-site inspections, and these contacts allow the supervisor to collect detailed information that facilitates a possible rating of the bank. The Basel Committee's Core Principles require regular contact between the supervisor and the bank as one of the main tools for an independent validation of supervisory information.

WHICH TYPES OF INSPECTIONS ARE CONDUCTED?

Inspections can take different forms and have different purposes. They can be grouped into three broad categories, namely:

- Regular inspections, which form part of the normal supervisory planning process and usually cover either the business of a bank in general or focus on a specific area such as market risk and market risk models;

- Special, thematic inspections that could focus on for instance activities that are common across a peer group or a special area in a number of institutions, e.g. how banks assess a new product, deal with the appointment of new management, or develop and test new risk management or IT systems; and

- Urgent inspections, which were not scheduled in the supervisory planning but are required to assess crisis events within the banking sector or the bank itself, or external threatening events that require special investigation.

WHAT STAGES ARE NORMALLY INVOLVED IN INSPECTIONS?

The legal framework for on-site inspections varies from country to country and is often correlated to the organisational structure of banking supervision within a particular country. The basic principles can for instance be embedded

in the banking act, the law on the supervisory body or a specific law relating to on-site supervision. As an example, in the Czech Republic the basic principles comprise a combination of the law on state control and the banking act. The level of freedom granted to supervisors in the national laws varies from being strict to being accommodative, leaving discretion to the supervisor to decide on how to fulfil the inspection mandate. The actual process followed in the conduct of inspections is relatively similar across countries and is summarised in the flow chart in Diagram 4.3.

The supervisory plan reflects the supervision cycle and the needs and priorities of the supervisor. Provided that the risk assessment is the same, the attention paid to a small regional bank is not comparable to that paid to a large bank, where the failure could have systemic implications. Nevertheless, even the most negligible bank from a financial stability perspective cannot be forgotten in the plan, and supervisors often are required to inspect a bank after a number of years, irrespective of the soundness of its operation. The main aspects covered

Diagram 4.3 Process for preparation, conduct and follow-up of the inspection of a bank

1) Transmission of report to the supervisor is relevant to cases where the report has been prepared by an author different from the supervisor, such as a central bank performing on-site inspections or an external auditor with a similar task.

by the supervisory plan are:

– a schedule of inspections in the bank;

– identification of the types of inspection to be conducted (regular or thematic, special inspection);

– risk classification of the bank related to the theme of inspection (how the bank rates on risks relating to the bank in general and its business, balance sheet, risks, etc.);

– the scope of examination (location: head office, domestic or foreign branch); and

– identification of the supervisor that will conduct the inspection.

These elements can also be described as a process where the supervisor tries to answer the following questions: *which* bank will be examined; *what* will be examined in the bank; *who* will examine the bank; and *when* and *where* will the bank be inspected (head office, network and/or branch)?

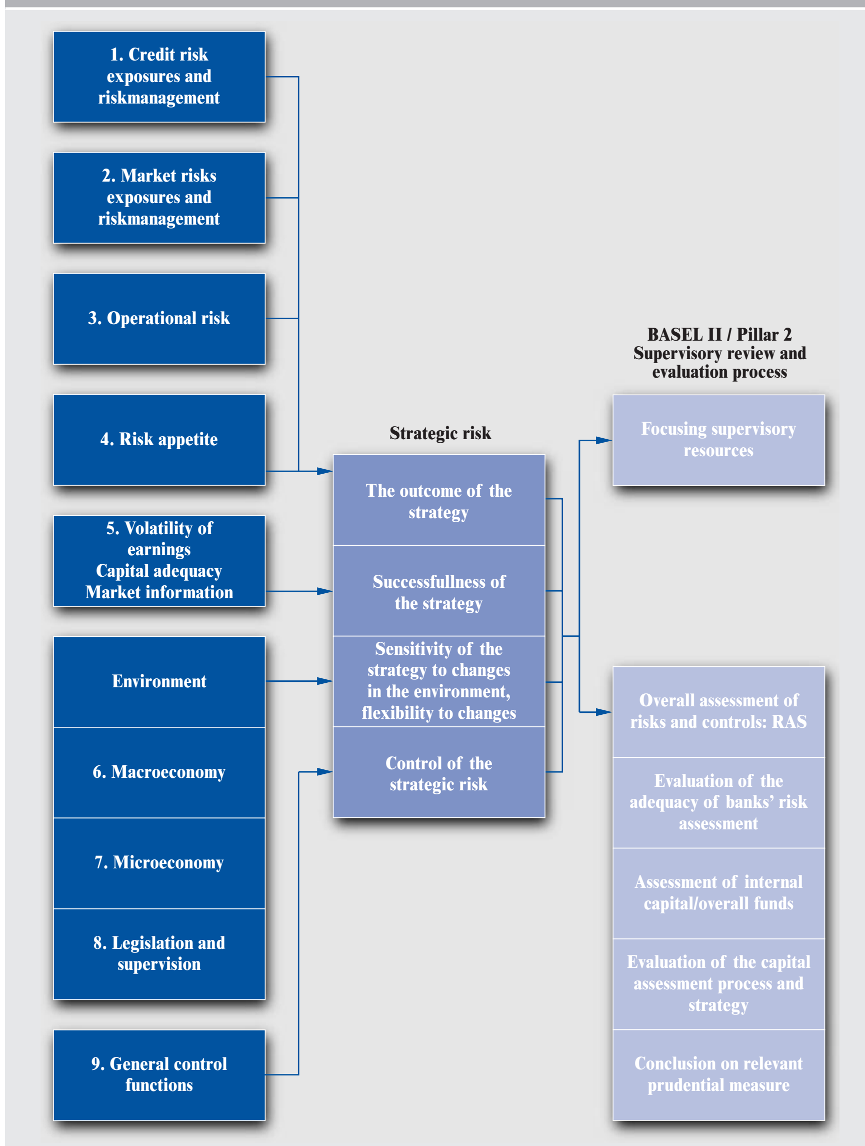
HOW CAN THE SUPERVISOR FOCUS INSPECTIONS ON RISKS?

Inspections in the EU are today risk-oriented, but also include compliance checking. This means the banking supervisor first of all aims to identify the main types of risks that the bank faces and the main factors driving these risks. This process is often carried out during the off-site supervision process. The inspection – which represents the second step – then pays special attention to the identified risks and the management and control system in these areas. The main objective of this risk assessment is that the supervisor obtains an assurance that the bank is complying with its own internal policies, that these policies work in practice, and that the bank is not taking on risks that could threaten its existence.

Diagram 4.4 provides an example of the risk focus in supervision. In Finland,[20] the Financial Supervision Authority follows an approach that evaluates credit, market and operational risk and the bank's risk appetite in order to define the outcome of the strategy. By analysing the volatility of earnings, capital adequacy and market information, the supervisor further assesses how successful the bank is in meeting its chosen strategy. The environment in which the bank operates in terms of economic developments and regulatory framework as well as internal control systems and policies is also fed into the overall assessment of the bank's strategic risk. The final outcome allows the supervisor to focus supervisory resources on high-risk institutions, but also contributes to the overall supervisory review and evaluation process as foreseen in pillar II under Basel II. Much of this approach requires inspections of individual banks, but it

20 Models for risk-based supervision that are somewhat similar to the one described for Finland are applied in other EU countries as well. In this book, however, only the Finnish example is described.

Diagram 4.4 Risk-based supervision approach by the Finnish Financial Supervision Authority



is in general an iterative process that shifts from off-site to on-site supervision and back to off-site routines.

In assigning risk scores, the Finnish process is structured around five risk classes and assesses both the quantitative elements (normative and relative level of risks) and the bank's internal control environment. An increasing level of risk leads to increasing requirements from the supervisor for the bank to put in place sophisticated risk management policies and practices that need to be

properly implemented and monitored. When a particular institution is classified as high risk, the exposure forms a threat to the existence of the institution and the supervisor in charge of that particular bank is required to present a back-up plan to deal with its potential failure.

Some of the advantages of this specific approach in terms of risk assessment and defining the scope and focus of on-site inspections are that it enables:

– an overall assessment of the bank to be made;

– major business lines to be identified;

– the type and direction of risk to be assessed;

Table 4.4 Risk-scores used by the Finnish Financial Supervision Authority in its risk-based supervision approach

Rating number	Interpretation of the number for exposures (quantitative risks)	Interpretation of the number for risk management (control)
1 No risk	There is no business activity generating this category of risk	No need for risk control
2 Low risk Strong control	Normal off- and on-site supervision is sufficient to assess and evaluate the exposure	Normal on-site inspections are sufficient to assess the risk management system for this risk
3 Fair risk Satisfactory control	The exposure is large compared to the peers and requires *actions within the supervisory body*: evaluation of the exposure in proposition to information of the over-all risk and risk management situation and risk tolerance.	The large size of the exposure triggers a deeper evaluation of the adequacy of the internal risk management or the internal risk management system is under development or in the phase of implementation and therefore needs special attention
4 Material risk Unsatisfactory control	The exposure is extensive and requires actions directed at the institution. Actions can be intensified reporting or a focused inspection. Arguments for keeping the exposure are required.	Risk management is inadequate and immediate strengthening of the system is needed.
5 High risk Weak control	The risk exposure forms a threat to the existence of the institution (generally strategic risk). The exposure calls for immediate discussions between the institution and the supervisor on the highest management level.	Severe weaknesses in controls: organisation, risk management or limits policy. The supervised entity is required to present a back-up plan.

- management quality to be assessed;
- the adequacy of the bank's risk management systems to be assessed;
- the probability of negative impacts on the bank to be identified, and a plan for addressing such situations to be elaborated.

HOW CAN THE SUPERVISOR ASSESS THE ADEQUACY OF BANKS' RISK MANAGEMENT?

In pursuing the risk-based supervision approach, the assessment of the adequacy of a bank's risk management system for the identified function or activity should be focused on the key elements of sound risk management. This includes active board and management oversight; adequate policies, procedures and limits; ongoing monitoring; management information systems, and comprehensive internal controls. A classification of risk management into strong, adequate and weak could, for instance, be built around the following three descriptions:

- Strong risk management, characterised by effective identification and control of all major types of risks that arise from the relevant activity or function. The board and management participate in risk management and ensure the existence of appropriate policies and limits which they understand, approve and regularly monitor. Policies and limits are supported by adequate risk monitoring procedures, reports and management information systems capable of making timely and appropriate responses to changing conditions. Internal controls and procedures reflect the size and activity of a bank. There are no significant exceptions from the approved policy or procedures which could lead to a substantial loss.

- Acceptable or adequate risk management, indicating that the bank's risk management system is largely effective, although it can suffer from some minor shortcomings. The bank is able to recognise its risk management weaknesses and to address them. Overall, board and management oversight, policies and limits, risk monitoring, reports and management information systems are considered effective in ensuring the safe and sound conduct of business. Risk management does not require greater supervisory attention than normal.

- Weak risk management, characterised by a lack of standard risk management, which requires more intensive supervisory attention. Weak risk management may have a significant impact on the soundness and safety of the bank and can lead to material misstatement of its financial situation if corrective actions are not taken.

The composite risk assessment for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk management systems for that activity. Commercial real estate loans, for example, are typically seen as carrying high risks that can, however,

be compensated for by very conservative loan underwriting procedures, effective credit administration, a strong internal loan review processes and good early warning systems. The overall risk profile of that particular activity could therefore be acceptable.

HOW DOES THE SUPERVISOR PREPARE FOR A BANK INSPECTION?

The preparation process for on-site inspections consists of two phases, one focusing on the collection of information, and the second on analysis in preparation for meeting the bank and discussing and assessing the most relevant issues. The supervisor gathers existing internal documentation for analysis as well as information from external sources about the bank in question. In the EU, correspondence between the bank and the supervisor is typically more extensive immediately before an inspection than between inspections. The supervisor typically requests additional materials and documentation from the bank. This can for instance include the latest information about the following:

- strategic plans and budget
- organisational structure
- operational rules
- internal risk reports
- profit and loss figures
- internal and external audit reports
- management reports
- reports on staff and their turnover.

Prior to inspection, the supervisor should examine all received material to obtain a comprehensive understanding of the bank's business activities and operating environment, and to estimate its risk profile. At the same time, the supervisor should work out an inspection plan that should at least cover details relating to:

- the composition of the inspection teams, taking into consideration the need for special examiner skills;
- the schedule of activities;
- an estimation of the time needed for conducting the examinations; and
- a determination of what tools are necessary, ensuring their availability.

WHAT ARE THE CONDITIONS FOR INDEPENDENT AND SUCCESSFUL EXAMINATIONS?

For inspections to be independent and successful, they should follow a few basic conditions. Examiners must be independent from external influences such as relations with bank management or politicians to ensure objectivity and impartiality in the outcome of the inspection. To ensure that independence is maintained and avoid complacency, it can be a good idea to change the team of supervisors responsible for a bank at regular intervals. Each activity during the inspection, even the most basic appointment with the bank's management, should be conducted by at least two examiners to avoid any misunderstandings. Each team of inspectors needs to have its own examiners responsible for assessing the appropriateness of the bank's risk management process for each business line. Where possible, the inspection should be conducted by two examiners working closely together on all aspects, as the four-eyes principle helps eliminate mistakes. The inspection team should have a nominated team leader who, in addition to coordinating the inspection, is the central contact point for the inspected bank, thus avoiding any duplicity or confusion with regard to any material requirements of the supervisors. During the preparation phase, communication between on-site and off-site supervisors must increase to secure coordination on the supervisor's side. It is also reasonable to expect intensified communication with the bank's management.

The so-called first day letter is in principle just an official announcement to the bank that the banking supervisor intends to inspect it. The letter can contain reference to specific legal provisions that allow the supervisor to carry out this inspection. More important for bank management and the conduct of the inspection is the mentioning of the topic of the inspection as well as the date when inspection will start. The letter can also contain the names of examiners that should be granted access to the inspected bank.

First day letters can, however, also play a role in connection with the cooperation between supervisors and central banks. The exhibit below is an Austrian letter from the supervisor to the central bank. As part of the Austrian structure for supervision, the supervisor requests the central bank to check a specific field of risks in a particular bank. The supervisor informs the central bank that the bank has been notified of this and that the supervisor wishes to be informed of the outcome by fax.

To ensure efficient and successful inspections, attention should be paid to the bank's standard business activity, and the supervisor should avoid interfering in business directly or distract management from their duties. The supervision team should follow a number of basic principles for on-site inspections:

- The inspection should emphasise that it is an independent review of the bank's internal documents, records and files which the bank cannot perform itself;
- The examiners should benefit from well-structured and efficient interviews with the bank's management and staff;

– The inspection should be conducted by professional examiners with a good knowledge of the business of the bank and a comprehensive understanding of what constitutes sound practices in banking;

– The findings should be conveyed to management or staff, as appropriate, if possible immediately;

Exhibit 4.1 Austrian letter from supervisor to central bank

FMA · FINANZMARKTAUFSICHT

RSb

B Eingelangt
Poststelle Oe. N. B.
– 6. Juni 2002
Mit ...... Beilagen

Bankenaufsicht

GZ. 23 5450/5-FMA-I/5/02

Plankengasse 3
A-1015 Wien
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Sachbearbeiter: Dr. Saukel
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An die
Oesterreichische Nationalbank
Abteilung für Bankenanalyse und -revision

Otto Wagner Platz 3
1090 Wien

PRÜFUNGSAUFTRAG
der Finanzmarktaufsichtsbehörde
an die Oesterreichische Nationalbank
gemäß § 70 Abs 1 Z 3 BWG

Identification of the bank to be examined

Der Oesterreichischen Nationalbank wird gemäß § 70 Abs 1 Z 3 in Verbindung mit § 79 Abs 4 BWG, BGBl Nr 532/1993, idgF, die Aufgabe übertragen, die ███████ im Sinne der Bestimmungen des § 70 BWG zu prüfen und dabei insbesondere die Kreditgestionierung und die Begrenzung der Kreditrisiken zu evaluieren.

The definition of the subject of the examination

Der ███████ wurde die Prüfung gemäß § 71 Abs 1 BWG mit Schreiben vom 3. Juni 2002 angekündigt. Die FMA ist mittels Fax über den tatsächlichen Prüfungsbeginn zu informieren.

3. Juni 2002
Finanzmarktaufsichtsbehörde
Für den Vorstand

Mag. Radl (AL) Dr. Saukel (AL)

- All findings should be recorded in the supervisor's protocol;
- All findings should be discussed with the bank's management;
- The result of the inspection should be summarised in the final report; and
- In case the inspection discovers serious shortcomings and breaches of the regulations or law, administrative and penal proceedings should immediately be initiated.

WHAT MIGHT THE SUPERVISOR FOCUS ON IN PRACTICAL TERMS DURING THE INSPECTION?

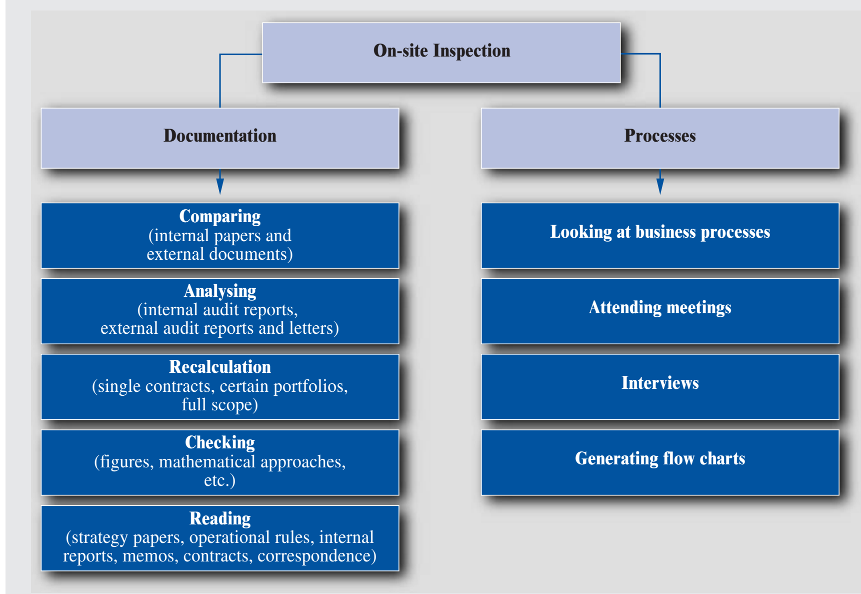
During inspections, the supervisor – like an auditor – looks at the broader picture by also testing and examining the details of the bank's documentation and processes. In examining the documentation, the supervisor may for instance wish to compare documents, analyse their content, recalculate and check figures and review other relevant documentation made available by the bank. To understand the processes of the bank, the supervisor may wish to look at the process from an outside perspective, join meetings that take place as part of the process, and interview staff involved in the process. On that basis, the supervisor should be able to draw up flow charts on the functioning of the process and assess adequacy against the bank's risk profile. The review of documents and processes is shown in Diagram 4.5.

WHAT PRECONDITIONS MUST BE MET FOR THE SUPERVISOR TO REVIEW DOCUMENTS AND PROCESSES?

The review of documents crucially depends on the supervisor having unrestricted access to all files and records and the right to copy documents, and these should be fixed in law. The volume of data in banks makes it necessary to use IT in analytical processes. One example is if the supervisor wishes to conduct an independent test of the bank's own models for market risk management, as these can be very complicated, requiring extraordinary computing power. Examiners can in this context prepare their own set of data for testing and run the data through the bank's system, knowing in advance what the supervisor would consider an acceptable outcome.

All working papers and protocols prepared by the supervisory team during the inspection, together with the examined bank's own documentation, where relevant, serve as evidence that the inspection was carried out in an appropriate manner and in compliance with the applicable laws and regulations. The final protocol will naturally be very sensitive, and the inspection team should therefore first discuss the report with colleagues involved in off-site supervision activities relating to the inspected bank. The objective of such a review is, apart from obtaining an independent opinion, to confirm that the final protocol is fully in compliance with internal standards and represents a correct assessment of the bank. As an example, the Swedish Financial Supervisory Authority ensures

Diagram 4.5 On-site review of documentation and processes



quality and consistency though a process that involves setting up a panel of colleagues that will challenge the findings of the supervision team. The panel may for instance review the risk assessment and issues raised in relation to the particular bank, and would seek to ascertain that the results are correct and well-documented in order to provide information on the likelihood of an event occurring and the potential impact of the event.

After finalisation by the supervisor, the protocol should be sent to the inspected bank for comments and approval. Depending on the national supervisory setting, the process might thereafter differ. In general, it is recommended that all significant disagreements are clarified and, where this is not possible, both the view of the supervisor and the view of the bank should be reflected in the final report to avoid any conflict, where possible. The protocol should include all findings and their solutions, recommendations and follow-up measures where action is needed.

4.3 CAPITAL ADEQUACY AND BASEL II

The supervisory review process – both off-site and on-site supervision – forms a very important part of the new Basel Capital Adequacy Framework, dubbed Basel II. The new framework will in many countries replace the Capital Accord launched in 1988 and amended in 1996 to incorporate market risks.

WHAT IS BASEL II?

The new capital framework consists of three pillars as shown in Diagram 4.6: minimum capital requirements; a supervisory review process; and disclosure to foster market discipline, whereby financial markets will support the work of supervisors in controlling banks and securing that they respect the minimum requirements.

Regulatory minimum capital requirements are still the key elements of the new approach, as in the previous Basel I framework. However, with Basel II, the Basel Committee has also emphasised the role and importance of the supervisory review. The formalisation of the supervisory review process has become especially important because Basel II allows sophisticated banks to use internal rating systems as the basis for calculating minimum capital requirements, instead of standardised methods and classifications of risk set on equal terms for banks.

WHAT ARE THE BASEL II CAPITAL REQUIREMENTS?

The minimum capital that a bank is required to hold is related to the risks it takes. The aim is to cover unexpected losses through own funds (capital and reserves). Specific provisions must cover expected losses. Compliance with minimum capital requirements is traditionally a key component in prudential supervision and this role is retained in Basel II.

Basically, Basel II does not alter the definition or components of own funds in the Basel I framework. The capital that supervisors consider eligible to cover the losses caused by materialised risks consists of shareholder equity and retained earnings (tier 1 or core capital), and supplementary capital (tier 2 or subordinate capital). Banks can also issue another type of capital based on short-term subordinated debt (tier 3), which can be used under special conditions to meet minimum capital requirements.

Diagram 4.6 The three pillars of the Basel II framework

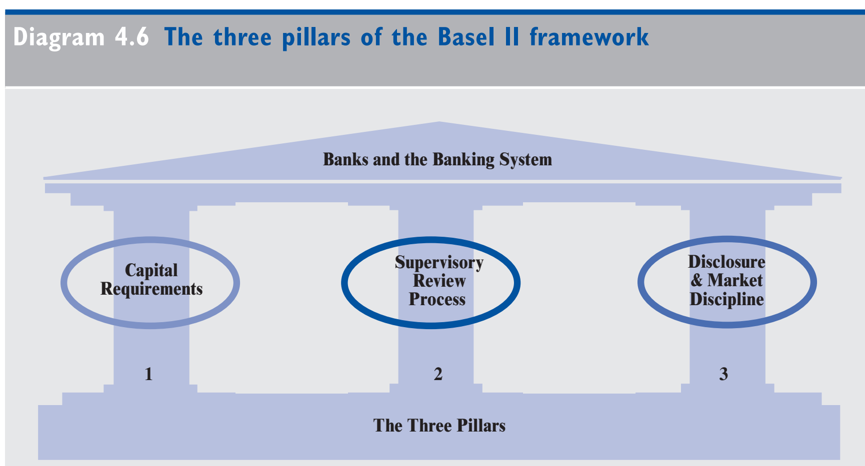
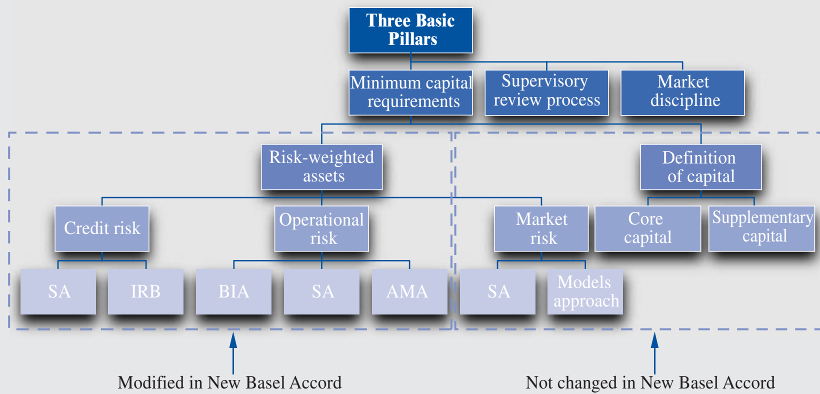


Diagram 4.7 Overview of new elements in minimum capital requirements with Basel II

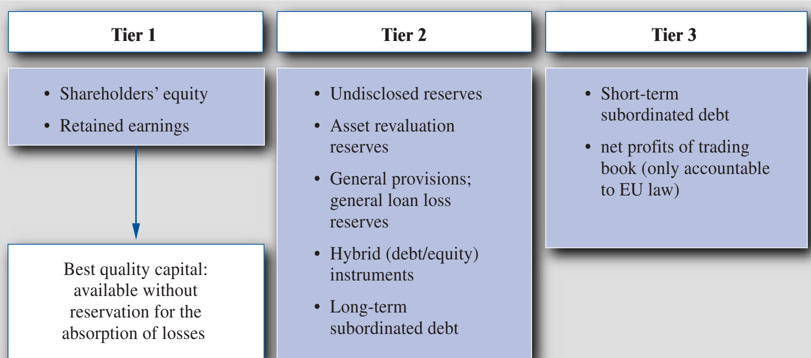


Note: Abbreviations used in the chart: SA = standardised approach. IRB = internal rating-based approach. BIA = basic indicator approach, AMA = advanced measurement approach.

The structure of capital presented in Diagram 4.8 is derived from the Basel Committee's Capital Accord. The first definition was presented in the document on the International Convergence of Capital Measurement and Capital Standards (the first Capital Accord) in 1988. Tier 3 capital was included in the Amendment to the Capital Accord to Incorporate Market Risk in 1996.

From the EU perspective the capital, in relation to capital adequacy, is defined in Council Directive 96/6/EEC of 15 March 1996, and subsequently in Council Directives 89/299/EEC of 17 April 1989 and 86/635/EEC of 8 December 1986.

Diagram 4.8 The structure of capital of banks by the Basel Committee to meet minimum capital requirements[1)]



1) Undisclosed reserves that are part of tier 2 regulatory capital are likely to diminish or disappear from banks' financial statements with the implementation of IFRS by the IASB, as undisclosed reserves are in principle not allowed to exist in IFRS-based financial statements.

The general requirement for minimum capital can be expressed as the following equation:

$$\textbf{Minimum ratio: } \frac{\textbf{Regulatory Capital}}{\textbf{Risk-weighted assets}} \textbf{ >=8\%}$$

The rules for calculating the minimum capital requirements have two fundamental components: regulatory capital and risk-weighted assets that, in the equation, must result in a minimum ratio of capital to risk-weighted assets equal to 8% or more. In computing risk-weighted assets, the bank must include the risk weight of off-balance sheet items.

Capital adequacy ratios may not be directly comparable between countries, as national supervisors can at their discretion define risk weights for certain types of assets or other adjustments. Even more importantly, national practices may vary in the valuation of assets or the recognition of loan losses and provisioning, which can significantly affect the ratio.

A major innovation in Basel II is the introduction of three distinct options for the calculation of credit risk and operational risk. The Basel Committee did not believe that it was feasible or desirable to insist on a standard that prescribes a "one-size-fits-all" approach to all banks in measuring these risks. Instead, three approaches exist for both credit as well as operational risk. These approaches vary in the level of sensitivity, and allow banks and supervisors to select the most appropriate approach reflecting the size, level of development and position on the market for each particular institution. More advanced models may lower the minimal capital but require banks to conduct better risk management which is then monitored by supervisors. The framework therefore creates incentives for banks to improve risk management and as a result to benefit from lower requirements to hold capital against risks. In essence, the new capital adequacy framework is consistent with the risk-based approach to supervision.

The standardised approach is largely similar to that of the previous capital accord. It sets fixed risk weights for each category of assets, but allows the use of external credit risk ratings or assessments to enhance risk sensitivity. The main underlying objective of the standardised approach was to find a balance between simplicity and accuracy, as supervisors did not expect all banks to move to the more sophisticated approaches. Most banks are expected to use this method either as a first step towards more sophisticated approaches, or because it represents the best fit to their own business and risk profile.

The internal ratings-based (IRB) approaches are new in Basel II. They move in the direction of allowing credit risk models for the calculation of capital requirements, but unlike credit risk models, do not take into account correlations

between different loans. The IRB approaches foresee that banks will develop a system for rating borrowers on the basis of the probability of default (PD) of the borrower, estimated over one year. In the foundation IRB, the supervisor will provide the bank with its estimation of the:

- loss given default (LDG);
- exposure of default (EAD);
- implicit or explicit maturity adjustment;
- expected losses; and
- unexpected losses.

Of the above five points, the two latter are derived on the basis of the three first poins. In the advanced IRB approach, the bank must be able to estimate the five above-mentioned points itself.

IRB approaches offer banks marginally lower capital requirements on exposures with borrowers which represent low credit risk and thereby create incentives for them to improve their credit risk management and measurement policies.

WHAT IS THE BASEL II SUPERVISORY REVIEW PROCESS?

The second pillar of Basel II focuses on key aspects of banking supervision. The goal of the supervisory review pillar is to ensure that the bank's capital is consistent with its overall risk profile. The review process should enable timely supervisory intervention in case the capital cannot cover the potential risks. Basel II identifies four key principles for the supervisory review. They supplement the Basel Committee's Core Principles for Effective Banking Supervision, and state that:

1. Supervisors expect banks to operate above the minimum regulatory capital ratios, and should have the ability to require banks to hold capital in excess of the minimum required.

2. A bank should have a process for assessing its overall capital adequacy in relation to its risk profile, as well as a strategy for maintaining its capital levels.

3. Supervisors should review and evaluate a bank's internal capital adequacy assessment and strategy, as well as its compliance with regulatory capital ratios.

4. Supervisors should seek to intervene at an early stage to prevent capital from falling below prudent levels.

Reasonable capital buffers are very useful for a bank. The five main reasons to keep the capital adequacy ratio above the minimum limit are:

– Competitiveness, where operation above minimum levels has a substantial, positive impact on the rating assigned by internationally recognised rating agencies. International banks therefore prefer to operate above Pillar 1 minimum requirements.

– Flexibility, where changes in the macroeconomic environment or the type and volume of activities can lead to fluctuations in capital. Cyclical market developments and economic conditions may also have an impact on capital adequacy. A bank should keep capital at higher levels than required to remain flexible and resistant to such deviations.

– Efficiency, because it can be costly for the bank to raise additional capital. This may especially be true if the need to obtain additional capital must be met quickly or at a time when market conditions are unfavourable.

– Prudence, where a drop below the minimum requirements for capital adequacy implies a breach of law that would lead to supervisors to take prompt corrective actions. For a bank this is a serious matter, with potential short and long-term financial consequences that should be avoided.

– Certainty, as there may be risks, either specific to the individual bank, or more generally related to current economic developments, that were not predicted and may represent unpleasant surprises. In holding more capital than needed, the bank may protect itself against issues that were not taken into account in Pillar 1 or in the bank's internal strategy for capital adequacy management.

WHAT IS THE BASEL II DISCLOSURE AND MARKET DISCIPLINE APPROACH?

The third pillar of Basel II sets minimum requirements for disclosure to enable other market participants to assess the bank's performance and capital adequacy and to exercise market discipline. Banks operate in financial markets as financial intermediaries, and all their counterparts have a strong interest in being able to assess the risk of engaging in business with each other. Supervisors usually refrain from making public their findings in relation to individual banks, and Basel II does not alter this practice. The new minimum requirements under Basel II supplement other requirements for disclosure such as those set out in connection with accounting and financial reporting. By stating that certain types of information are mandatory and by securing comparability, Pillar 3 aims at invoking market discipline as an instrument that can assist the supervisor in maintaining a safe and sound banking environment.

5 CRISIS MANAGEMENT AND BANK REHABILITATION

Weak banks can be found in all countries and are not a phenomenon restricted to transition or emerging market countries. This chapter describes what weak banks are, the causes and symptoms of such weaknesses, the internationally shared principles for bank crisis resolution, and the corrective tools that supervisors should have in order to address the problem of weak banks. The chapter also describes supervisory interventions to resolve a bank crisis in a situation where the bank's weaknesses have gone beyond the point of correction so that the bank needs to be liquidated. Finally, the chapter describes the role that deposit insurance systems can play in this context.

After reading this chapter, the reader should understand:

- what a weak bank is, and the causes and symptoms of weaknesses in a bank;

- the internationally shared principles for bank crisis resolution and the tools, or corrective actions, that supervisors have to improve the bank's situation;

- the different forms of supervisory interventions that can successfully reorganise a bank or order it into liquidation; and

- the roles that deposit insurance systems can play in crisis management and bank rehabilitation.

WHAT IS A WEAK BANK AND WHAT ARE THE CAUSES AND SYMPTOMS OF BANK WEAKNESSES?

The Basel Committee defines a weak bank as one "whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management."[21]

Although responsibility for the resolution of problems clearly resides with the bank's management board, banking supervisors should be ready to deal with these problems as well. This means that the supervisor should be able to:

- identify weaknesses at an early stage;

- stimulate corrective actions by the bank itself, where needed; and

- identify and timely implement resolution techniques, when the problem cannot be resolved by the institution itself, aimed at the reorganisation or the liquidation of the bank at the lowest possible cost.

21 Basel Committee (2002), "Supervisory Guidance on Dealing with Weak Banks", Report of the Task Force on Dealing with Weak Banks, March.

In order to correct problems at a bank, it is important to understand and identify the symptoms and the causes of the crisis. The *symptoms* of weaknesses are usually a lack of profitability, insufficient capital, poor asset quality and liquidity problems. These can lead to reputational problems. The *causes* include a wide range of factors, including:

– *strategic failures* (in market positioning, the structure and size of the banks network and internal organisation);

– *risk management failures* (risk assessment, management and monitoring, internal controls, operational and decision-making processes);

– *regulatory violations or fraud* (unsound lending practices, lack of transparency in the bank's ownership structure, etc.); and

– *exogenous factors* (negative developments in market conditions, unexpected external shocks, etc.).

Experience from several countries indicates that liquidity problems rarely occur in isolation. They usually indicate broader difficulties, where a substantial part continues to be caused by credit problems. Credit losses are caused by shortcomings in risk management and control processes which were not sufficiently strong to prevent poor lending practices, excessive loan concentration, excessive risk taking, overrides of policies and procedures, fraud or other criminal activities.

Weaknesses in a bank tend to grow over time if not identified. The proper identification of weak banks depends on the information gathered by the supervisor from the wide variety of sources described in Chapter 4 on on-site and off-site supervision.

WHAT ARE THE INTERNATIONALLY SHARED PRINCIPLES FOR RESOLVING BANKING CRISES, AND WHAT TOOLS SHOULD SUPERVISORS HAVE IN ORDER TO DEAL WITH CRISES?

A number of international working groups and fora have defined a set of standard principles and guidelines for good practices in banking crisis management and resolution.[22] The *aims* of a good system of banking crisis management are:

– to avoid disruption to the payment and securities settlement system;

– to prevent difficulties at one institution from affecting other institutions and turning into systemic instability (the domino effect);

22 Financial Stability Forum (2001), "Guidance for Developing Effective Deposit Insurance Systems", September; Basel Committee (2002), "Supervisory Guidance on Dealing with Weak Banks", in cooperation with the IMF, World Bank and the Financial Stability Institute, March; BIS/G10 (2002), "Legal and Institutional Underpinnings of the International Financial System", September; World Bank/IMF, "Bank Insolvency Initiative", ongoing in 2005.

– to preserve public confidence in the financial system; and

– to minimise disruption to the productive system (the real economy).

The basic principles are that:

– bank failures are a consequence of risk-taking in a competitive environment[23];

– private sector solutions are best: public funds in the form of taxpayers' money are only for exceptional circumstances (systemic risk); state intervention should not be predictable (so-called constructive ambiguity), nor benefit shareholders and managers (in order to reduce moral hazard incentives);

– expedient resolution processes are preferable: least cost solutions for the State or the deposit insurance system should be chosen;

– the protection of the business unity (firm's value) and continuity (relationships with customers) should be pursued, where feasible: mergers and acquisitions (M&As) and purchase and assumption (P&A) transactions are preferable in respect of piecemeal liquidation;

– fair and equitable treatment of the stakeholders shall apply, and there must be clear rules for distribution of losses among stakeholders;

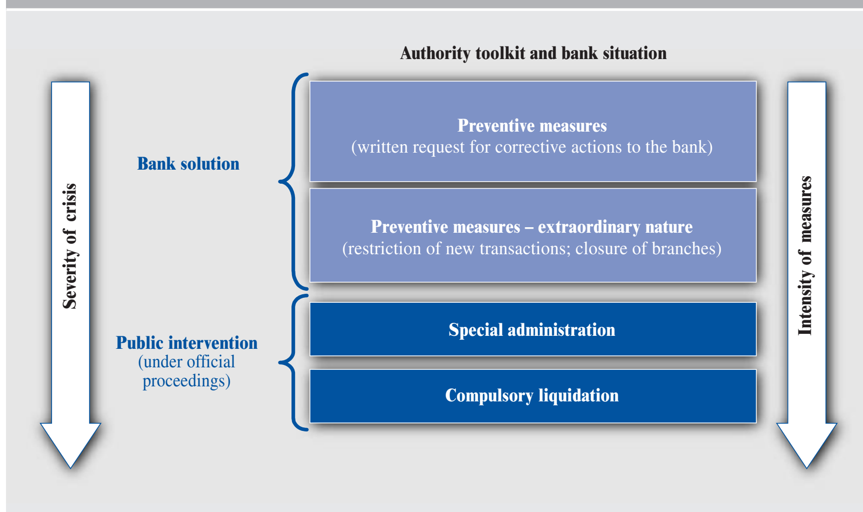
– accountability and transparency of restructuring are necessary to ensure legal certainty on the effects of insolvency on contracts and creditors; and

– protection of less sophisticated depositors (*unaware depositors*) from losses in case of bank failure must be ensured.

Timely assessment and effective crisis prevention and management are the basic conditions for successful crisis resolution. Supervisors should be allowed full discretion in analysing the degree of distress of the bank and in selecting corrective measures. This process may follow a process – as shown in the diagram below – of progression in the intensity of supervisory measures in line with the severity of the bank's problems.

23 This is an issue which has exercised many prominent central bankers. "We see it as our task to provide a regime in which the users of financial services can benefit from robust competition among financial firms, which will not happen unless each individual firm takes on some risk. But at the same time, we must ensure that there is public confidence in the monetary system as a whole […] a bank failure [does not] necessarily represent a failure of banking supervision" (E. George, former Governor of the Bank of England, speech given at the London School of Economics, 18 November 1993). "Our goals as supervisors, therefore, should not be to prevent all bank failures, but to maintain sufficient prudential standards so that banking problems do not become widespread" (A. Greenspan, Governor of the Federal Reserve Bank, speech given at the International Conference of Banking Supervisors, Stockholm, Sweden, 13 June 1996).

Diagram 5.1 Progression of intensity of supervisory measures in line with the severity of the bank's problems



Corrective actions are designed to deal with the identified deficiencies and thereby change the behaviour of the weak bank. Normally, bank management is responsible for determining how to solve growing problems. However, if the bank has unsound banking practices or has breached key supervisory requirements such as capital adequacy or liquidity, corrective actions may be implemented. Diagramm 5.1 above distinguishes between measures that are mild versus ones that are strong, where the latter are characterised as having an extraordinary nature. The implementation of corrective, preventive measures may be under strong supervisory oversight or could see the supervisor replacing management to take direct control of the bank, which is represented in the Diagramm by the two lower bars.

In more detail, the supervisor should have at its disposal, and hence formally embedded in its mandate, a sufficient number of tools available to deal with weak banks. Depending on the main cause of the weakness, the supervisor can consider implementing tools that primarily affect shareholders, management or the bank's business policies more broadly.

Corrective tools that have an impact on shareholders include:

– a call for cash (equity) injection by shareholders;

– a suspension of specific or all shareholders rights, including voting rights; and

– the prohibition of profit distribution or other withdrawals by shareholders.

In case the supervisor decides to suspend voting rights, particular attention should be taken to avoid that this does not block subsequent changes that need approval by a general assembly, such as the writing down of the nominal value of shares or the approval to liquidate the company.

Corrective tools that have an impact on directors and managers include:

– the removal of directors and managers; and

– the limitation of financial compensation to directors and senior executive officers, for instance by blocking bonuses or stock option programmes.

Corrective tools that have an impact on the bank's business policies more broadly include:

– introducing instructions and orders to restore soundness and remove irregularities, such as

  – requiring the bank to enhance governance structures, internal control or risk management policies and systems;

  – setting higher than normal capital adequacy or liquidity ratios that the bank has to fulfil;

  – imposing restrictions or conditions on the businesses conducted by the bank, such as prohibiting or limiting particular lines of business, products or customer relationships,

  – downsizing operations and selling assets;

  – restricting the continued expansion of the branch network or closing branches;

  – implementing immediate, enhanced provisioning against losses on bad assets;

  – banning principal or interest payments on subordinated debt;

  – stopping specific practices that harm the bank, its profitability or its reputation;

  – imposing the need for prior supervisory approval of any major capital expenditures, material commitments or contingent liabilities;

– arranging a takeover by or a merger with healthier banks;

– appointing an administrator that assumes the day-to-day operation of the bank (special administration or other public intervention for the reorganisation of the bank); and

– revoking the bank's banking licence and implementing its compulsory liquidation.

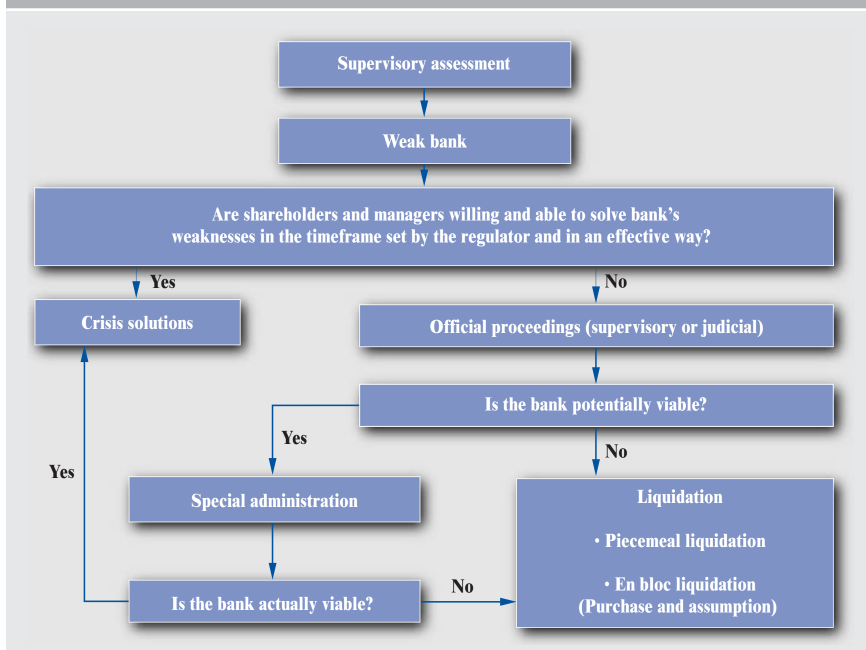
Section 5.1 below includes a description of the decision process that the supervisor could apply to identify the appropriate measures for crisis management.

5.1 CRISIS MANAGEMENT TECHNIQUES

Specific crisis management skills are needed when a bank faces serious problems. The following flow chart in Diagram 5.2 describes a possible decision-making process that the supervisor could apply to identify the severity of the problem and the appropriate response.

The key question in the decision-making process is whether shareholders and the bank's management are willing and able to solve the bank's problems. If that

Diagram 5.2 Decision-tree in crisis management situations



is the case, the supervisory can rely on market-based or assisted solutions (for instance with support from the deposit insurance system or the state). In the best of situations, solutions are adopted by the bank itself. When this is not the case, the supervisor or another authority can seek to provide a solution to the crisis. In a worst-case scenario, public solutions are necessary. In this context, one might also wish to think of crisis solution typologies, where the first type of classification is the *manner* in which the solution is achieved, and the second classification is *who* actually implements it.

The three solutions based on the manner in which it is achieved are:

a) *market solutions* (achieved with no external support);

b) *assisted solutions* (achieved with external support by the deposit insurance systems or by the state);

c) *public solutions* (achieved through direct state intervention).

The answer to the question as to who implements the solution can be split into two categories:

a) *self-adopted solutions* (via the bank itself)

b) *authority-led solutions* (via the bank under official proceedings, managed by supervisors or judicial authority: conservatorship/special administration, compulsory liquidation).

Diagram 5.3 Graphical illustration of classification of crisis solutions

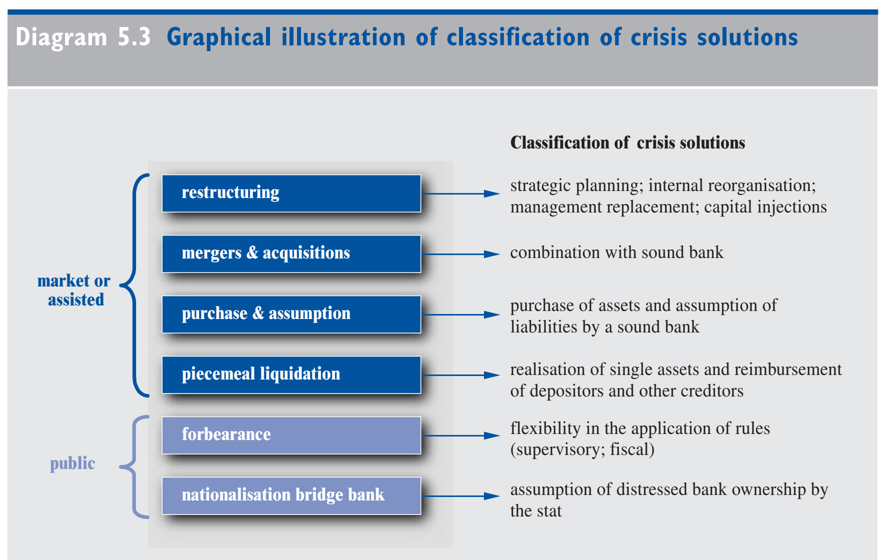
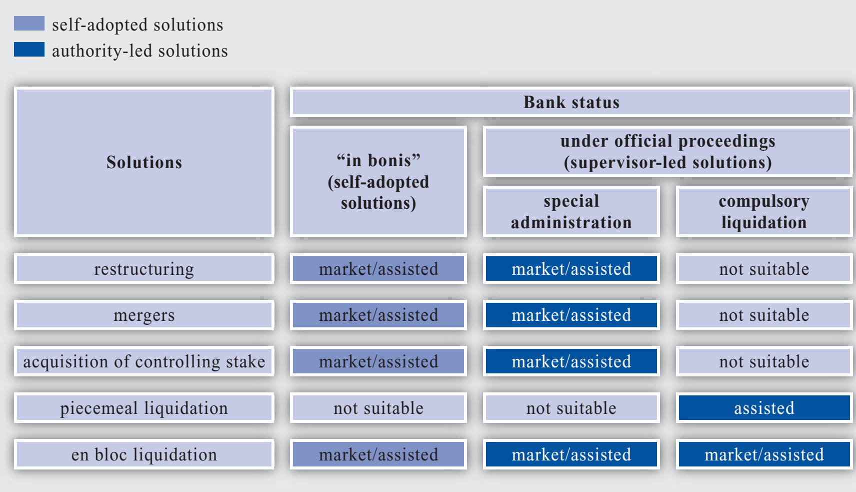


Diagram 5.4 Types of solutions in crisis situations



self-adopted solutions
authority-led solutions

Solutions	Bank status		
	“in bonis” (self-adopted solutions)	under official proceedings (supervisor-led solutions)	
		special administration	compulsory liquidation
restructuring	market/assisted	market/assisted	not suitable
mergers	market/assisted	market/assisted	not suitable
acquisition of controlling stake	market/assisted	market/assisted	not suitable
piecemeal liquidation	not suitable	not suitable	assisted
en bloc liquidation	market/assisted	market/assisted	market/assisted

WHAT RESOLUTION TECHNIQUES CAN BE USED IN CRISIS MANAGEMENT AND BANK REHABILITATION?

A bank that is on the verge of failure faces enormous difficulties. The lack of liquidity is one of these problems, but the bank is at the same time insolvent and desperately needs outside support. Different techniques can be used, including liquidation, depending on the stage the crisis has reached and whether or not it is possible to overcome it.

Special legal skills are required to resolve the problems relating to a failed bank. The following measures need to be drawn up:

– A restructuring plan;

– A merger or an acquisition with another bank;

– A purchase and assumption transaction or piecemeal liquidation; or

– A “bridge bank” solution.

WHAT ARE THE ELEMENTS IN A RESTRUCTURING PLAN AND WHAT IS THE AIM?

A restructuring plan includes a substantial, radical restructuring of the bank’s organisational structure and business plan. This only represents a viable solution if there are reasons to believe that there is a chance of getting the business back onto a sound footing in a short time. When the board of directors, the management or the major shareholders of the bank are reluctant to take the necessary action, the supervisor should consider appointing an administrator to draw up the restructuring plan and implement its initial phases (special administration). In such cases, the administrator should replace the existing

management and basically run the bank on a temporary basis. When the bank has been restructured, a new management must be appointed, as the previous management was deemed not fit to run the bank. If major shareholders failed to cooperate in this process, then they would probably also have to be replaced, by requesting them to sell their holdings.

WHAT ARE THE ELEMENTS IN MERGERS AND ACQUISITIONS AND WHAT IS THEIR AIM?

A troubled bank can be attractive to an investor, depending on the bank's characteristics. A competitor to the distressed bank that is seeking instant access to a particular market segment, or wants to acquire an attractive pool of low-cost deposits or to enlarge its distribution network would be interested in purchasing a failing bank if it possesses one or more of these features. The purchaser expects to be able to acquire these assets at a good/reasonable price with almost instant benefit.

The supervisor must take urgent steps to organise M&As before the assets of the troubled bank lose their value. M&As are not only legal actions that need legal consideration. The supervisor should consider all aspects and risks, including for instance the difference in organisation of the acquirer and target, their different corporate cultures, possibly incompatible IT systems, and the integration of staff of the failing bank into the acquiring bank. The acquirer should have full and transparent information about the weaknesses of the troubled bank. Confidentiality of the acquired information must be ensured through special agreements or by involving the supervisor.

An M&A can offer the following advantages:

- It maintains the failing bank as a going concern and thereby preserves the value of assets. This can minimise the cost to taxpayers and the deposit insurance system, which would otherwise assume all the costs of the failure;

- It minimises the impact on markets, as banking services to customers are not disrupted; and

- It transfers all assets, thereby fully protecting the claims of depositors and creditors.

In case the shareholders decide not to cooperate, i.e. decide not to sell their holdings or to approve the merger, the supervisor should consider the possibility of appointing an external administrator to assume the powers of the management and exerting pressure on the shareholders persuading them to sell their shares; failing which the majority of the shares could be expropriated. Alternatively, the supervisor might liquidate the bank and realize a P&A transaction.

WHAT ARE THE ELEMENTS IN PURCHASE AND ASSUMPTION TRANSACTIONS OR PIECEMEAL LIQUIDATIONS AND WHAT IS THEIR AIM?

A P&A transaction is an en bloc liquidation of the bank; it allows a healthy bank to purchase some or all of the assets of the failed bank, thereby assuming some or all of its liabilities. The purchaser assumes the business of a failed bank without realising a merger.

The P&A transaction can be structured in different ways to suit the objectives of the deposit insurer, the acquirer or the state. The acquirer is usually willing to purchase a business with a positive net asset value. The state and the deposit insurer's target is to transfer all deposits of clients, thereby limiting the burden on taxpayers or the participants in the deposit insurance system.

P&A transaction should – as with M&As – be completed as quickly as possible so that the business of the failing bank is not be interrupted. In many cases in the past, it has proven possible to complete P&A transactions over a weekend, thereby limiting the cost of the transaction. The acquirer must be a bank and have a banking license in order to be allowed to conduct the business acquired. The acquirer must also have the organisational and technical capability to run a banking business and manage all the shortcomings of the failed bank.

If a P&A transaction is not feasible, the alternative is piecemeal liquidation, i.e. the selling of assets and reimbursement of creditors of the bank, with the possible intervention of the deposit insurance systems.

A P&A transaction can have the following advantages, compared to piecemeal liquidation:

– It saves the value of assets of the failed bank as a going concern;

– It minimises the impact on markets; and

– Customers do not suffer a loss of service, and have immediate access to their funds at the acquiring bank.

WHAT ARE THE ELEMENTS IN A BRIDGE BANK SOLUTION AND THEIR AIM?

A bridge bank solution may be needed for crisis management and bank rehabilitation when a permanent acquirer is missing. The failing bank is closed by the supervisor (licensing authority) and liquidated. A new bank, in the form of a bridge bank owned by the state, is established, licensed and managed by a liquidator, which decides on the assets and liabilities to be transferred to the bridge bank. The bridge bank will eventually be sold to private shareholders.

The assets and liabilities that are not transferred to the bridge bank are normally liquidated in accordance with national legal procedures. If possible, the final solution – i.e. the sale of the bridge bank – should be identified as quickly as possible. As time passes, there is a risk that the value of assets will decline in

bridge bank solutions, and that clients will move to other banks, thereby impacting on the performance of what was established as a healthy bridge bank.

This technique is a form of direct state intervention, such as the nationalisation of the distressed bank. According to the general principles of banking crisis resolution in a private banking system, state intervention should be admitted only in cases where crises have a systemic implication and for a limited period of time. Otherwise, the bank should be liquidated through a P&A transaction or a piecemeal liquidation, with the possible intervention of the deposit insurance systems.

5.2 STATE AND DEPOSIT INSURANCE INVOLVEMENT

In general, public funds – or taxpayer money – should only be used in exceptional cases. Individual banks are commercial operators that risk going bankrupt, and public intervention should therefore be restricted to the protection of depositors and situations where there is a threat of substantial damage to the entire financial system and thereby a potential systemic crisis. For more information on financial stability monitoring, please see Chapter 7.

The possible forms of state involvement in crisis management and bank rehabilitation include:

- supporting the transaction whereby a weak bank is transferred to an acquirer (a P&A transaction);

- providing a direct capital injection;

- purchasing the bad assets of a failing bank. These assets are subsequently unwound by the state, typically through a special agency under state control; and

- nationalising or formulating a bridge bank solution.

In all cases, close cooperation is essential between the government (which is politically responsible for public funds), the supervisor and the central bank (which may provide emergency liquidity assistance).

Full support, where the state assumes all the cost of failure in the financial sector, can be extremely costly and raises problems of moral hazard, as market participants have no incentives to operate in a sound and prudent manner if they expect such interventions. If there is a full state guarantee on failures in the financial sector, all stakeholders will blindly and aggressively pursue the highest possible returns, as they are insured against the risk of losses should their business prove unsuccessful. To avoid this problem, shareholders must understand that their rights disappear when a bank fails, and that they therefore

have incentives to appoint a management that on the one hand increases shareholder return but on the other hand secures the value of shares. Ensuring public understanding and acceptance of the limits of public support to bank failures is not easy, but it is necessary.

Deposit insurance makes an important contribution to building or maintaining trust in the national banking system. While the supervisor's main objective is to protect depositors and public confidence in the banking system, a system that explicitly guarantees a certain amount of deposited funds can establish public trust to a substantial degree. In some EU countries, deposit insurance systems can contribute to strengthening crisis management when their intervention is less expensive than covering depositors' losses in case the bank is forced to close. They may assist in restructuring, M&As or P&A transactions, or reimburse depositors in case of piecemeal liquidation.

HOW IS DEPOSIT INSURANCE ORGANISED IN THE EU?

Deposit protection within the EU is based on EU Directive 94/19/EC enacted on 30 May 1994 and transposed into the national law of each Member State.

In accordance with this Directive, each Member State is obliged to protect deposits. Deposits are defined as any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution.

A credit institution is defined as an undertaking, the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account.

A credit institution must be a member of a protection scheme. In the EU, different systems exist with different levels of state involvement. National deposit protection agencies can be established on a private basis and fully financed by credit institutions, but they can also take the form of a government unit supported or guaranteed by the state. There are other systems in the EU where banks are obliged to make ex ante contributions, as well as systems where contributions are made ex post. Irrespective of whether the national scheme is fully funded or just partially funded, the funds collected and managed by the agency would not be sufficient to cover the failure of a systemically important institution, for example. In this case, the state may be required to intervene.

In principle, deposit protection schemes are dormant and only become active and effective in the event depositors are not able to access their deposits. Depositors are covered up to the amount set by the law. In the EU, the Directive stipulates that the minimum amount insured in each EU Member State must be €20,000. In case a depositor has a deposit exceeding the insured amount, the excess uninsured amount becomes a claim of the depositor in the liquidation of the bank.

6 MONEY LAUNDERING PREVENTION

Fighting money laundering is not just an issue for the banking sector alone, but the banking sector does risk playing a key role in the process of laundering money. Banks' increasing ability to transfer funds rapidly in an anonymous, automated manner makes them a target of criminal activity, and if banks do not pay due attention to a number of anti-money laundering issues, they could unwittingly be used by money launderers for criminal purposes. This can have devastating implications for banks as it poses a significant threat to public confidence and indeed to the future of the bank in question.

This chapter first describes and discusses the nature of money laundering, how it is carried out, and its effects. The chapter then examines international recommendations for combating money laundering, and assesses how supervisors can work with these recommendations.

After reading this chapter, the reader should be familiar with money laundering concepts, and should understand how banks can protect their organisations from being used by money launderers, and how supervisors can control banks' adherence to these international standards.

WHAT IS MONEY LAUNDERING AND HOW IS IT CARRIED OUT?

The Financial Action Task Force on Money Laundering (FATF), which is described in greater detail in Chapter 2 on the regulation and supervision of banks, defines *money laundering* as "the processing of criminal proceeds with the aim to disguise their illegal origin".

There are numerous activities which generate illegal income, such as illegal arms sales, smuggling, drug trafficking, prostitution, embezzlement, insider trading and computer fraud. Because such activities are criminal, the profits generated and subsequently laundered are not captured in official statistics. The IMF estimates that global money laundering could amount to anywhere between 2 and 5% of the world's gross domestic product. Using 2004 statistics, these percentages indicate that money laundering could range between 810 billion and 2 trillion USD.

The FATF describes three stages through which money laundering is carried out. In the first stage – *placement* – the launderer introduces the illegal money/profits into the financial system, for instance in small sums, as these look less suspicious than large amounts. Once the money is in the system, the second stage can start – the *layering* stage. This is where the launderer tries to disguise the origin of the money through a series of transactions (buying and selling securities) or movements (domestic or cross-border transfers) that can be portrayed as representing payment for goods or services. In the third and final stage – *integration* – the launderer reintroduces the money into the legitimate economy and traditionally invests it in real estate, luxury assets or business ventures.

The placement and layering stages are the most critical phases for banks. Launderers have been successful in their efforts if the bank is unable to identify suspicious customers or transactions and deal with these accordingly. This might be because the bank does not pay sufficient attention to these issues, because staff members are not sufficiently trained, or because bank employees or directors have been bribed to ignore the criminal nature of suspicious funds. In the latter case the bank clearly becomes part of the criminal chain.

Money laundering is in principle organised globally, although the funds are usually processed in relatively close proximity to the place where the funds originate. The layering stage, where transactions or transfers take place, is usually realised in offshore financial centres or international banking centres, as these provide adequate financial infrastructures that are large and anonymous enough to allow the sums transferred by launderers to disappear. The integration phase is typically chosen by the launderer in accordance with personal preferences. Favourite locations are for instance unstable economies, countries in transition that need investment, or places that normally offer only limited investment opportunities.

Money laundering methods and techniques are rapidly changing, and are making increasingly sophisticated use of complex legal structures. This in turn makes the need for professional behaviour on the part of the people who are charged with identifying money laundering all the more vital.

WHY DOES MONEY LAUNDERING NEED TO BE COMBATED, AND WHAT CAN BANKS AND SUPERVISORS DO IN THIS REGARD?

The fact that organised crime can infiltrate financial institutions, acquire control of large sectors of the economy through investments, or bribe public officials and indeed governments, stresses how important it is for states, regulators and international institutions to fight money laundering effectively. Democracy itself can be threatened if criminal organisations are permitted to exercise economic and political influence, leading to a weakening of collective ethical standards, and putting pressure on the democratic institutions that otherwise uphold the rule of law.

Countries have different approaches to regulation of anti-money laundering activities. The responsibility for regulating anti-money laundering differs from country to country. In some cases the banking supervision body is involved, whereas in other cases responsibility rests with a separate state agency. The following general requirements need to be ensured:

- The state should criminalise money laundering and terrorist financing as well as any contribution to these activities;

- The state should set up procedures that comply with internationally accepted principles; and

– The state should enable laundered property and funds to be confiscated as well as the proceeds from money laundering or terrorist financing that has been used or is intended for use in such offences.

In 1990 the FATF defined 40 recommendations to help financial institutions, governments and regulators combat money laundering. This list was last amended in 2003 and supplemented by special recommendations on how to combat terrorist financing. Today, the FATF recommendations provide an enhanced, comprehensive and consistent framework of measures for combating money laundering and the financing of terrorist activities. They cover the following aspects:

– customer identification;

– monitoring of accounts and transactions;

– record-keeping and the reporting of suspicious transactions;

– internal controls and audit;

– integrity standards; and

– cooperation between supervisors and other competent authorities.

Whereas all of these aspects in combination establish the framework of requirements to be ensured by states, regulators and financial institutions, the key issues to be pursued by banks are how to identify suspicious customers and suspicious transactions. Banks should know whom they are dealing with, and must establish adequate controls and procedures as well as due diligence processes for new and existing customers.

WHAT ARE "SUSPICIOUS CUSTOMERS" AND HOW CAN THEY BE IDENTIFIED?

The Basel Committee has issued a package of principles to be followed by financial institutions and regulators to enhance "know your customer" policies ("KYC policy").[24] In accordance with these principles, the banks should develop and elaborate their own customer acceptance policy, taking into account the risk profile of each customer. Various risk indicators, such as the customer's country of origin, public or high-profile position, business activities and linked accounts, determine the risk profile. Depending on the risk level, banks' KYC policy can include not too restrictive rules for opening basic accounts, whereas comprehensive due diligence processes should apply to customers that make use of more sophisticated banking services.

24 "Customer Due Diligence for Banks", Basel Committee, October 2001.

The following have high risk profiles, i.e. where the risk of money laundering is much greater:

- Customers who use fronts (such as trusts or corporate/professional intermediaries) to open an account, thereby hiding their true identity;

- Customers using private banking operations that by their very nature involve high levels of confidentiality;

- Customers that are politically or publicly exposed;

- Newly established businesses where only a limited level of due diligence is possible; and

- Correspondent banking activities, especially in cases where the bank originates from a country without adequate regulations or a country known to have poor KYC practices.

WHAT ARE "SUSPICIOUS TRANSACTIONS" AND HOW CAN THEY BE IDENTIFIED?

Ongoing monitoring is essential to make KYC procedures effective. For a bank this implies understanding the activities of an individual customer relative to the customer's profile. The aim is to be able to spot customer transactions that do not follow the normal pattern of the customer and that are therefore suspicious. Without proper procedures and ongoing monitoring, the bank could fail to meet its obligation to report suspicious transactions.

More precisely, suspicious transactions are those that lead to reasonable suspicion that they could be related to money laundering or the financing of terrorist activity. Reasonable suspicion depends crucially on an analysis of the normal business and financial behaviour of the client.

The techniques used to monitor transactions must be risk-sensitive. It can be very useful, for instance, to set limits for a particular class or category of accounts and analyse transactions exceeding these limits. Analysis of transactions which do not make economic or commercial sense as being normal for a particular customer can be very helpful, but also quite demanding in terms of technical and human resources as well as system implementation. The main aspects to be considered when analysing suspicious transactions are:

- the *amount of money involved in the transaction.* Generally it does not matter whether the amount is small or large. The relevant point to analyse is the amount in relation to a customer's expected and standard practice. For instance, a large amount deposited on the account of a restaurant owner that substantially exceeds normal daily receipts is suspicious. Also suspicious are weekly small deposits on the account of an employee with a monthly salary, as well as huge deposits on the accounts of politicians or state employees;

- the *frequency of transactions,* where repeated small transactions can take place in order to remain below certain limits that would otherwise lead to reporting requirements, e.g. in relation to foreign exchange or capital account movements;

- the *purpose of the transaction,* where for instance transfers to cover the purchase of an expensive car by a butcher could be seen as unusual, as could mortgage payments in favour of an individual's account as opposed to a mortgage bank;

- the *sequence of payments,* where the same amount paid periodically in favour of different accounts, or debits following credits of the same amount in an account, is suspicious; and

- the *balance on an account,* where the bank might look for accounts that always carry minimum balances but have a large turnover, or "dead" accounts – ones without transactions – with a large balance.

A final point relates to the role of training. Both supervisors and financial institutions are responsible for providing adequate training arrangements for their staff. It is extremely important to share both good and bad experiences in combating money laundering and terrorist financing. Supervisors expect each institution to make a member of staff responsible for regular training programmes and education of that institution's staff in the area of money laundering.

7 FINANCIAL STABILITY MONITORING

This final chapter goes beyond traditional supervisory policies and practices, which tend to look at individual institutions, and looks at the wider issue of financial stability. The chapter first proposes a definition of financial stability and an analytical framework for financial stability monitoring. It then addresses indicators and elements that can form part of a framework for ongoing financial stability monitoring.

After reading this chapter, the reader should understand that financial stability is more than just the survival of individual institutions or the stability and health of the banking sector. The reader should also be aware of the emerging framework for financial stability analysis and monitoring, and the indicators and elements that can be used in this context.

HOW CAN FINANCIAL STABILITY BE DEFINED?

There are many definitions of financial stability. The ECB has defined financial stability as "*a condition where the financial system is able to withstand shocks without giving way to cumulative processes which impair the allocation of savings into investment and the processing of payments in the economy*".[25] This is a practical rather than an academic definition of financial stability, which contributes to the monitoring activities and to policy decisions at the ECB.[26]

What is the financial system? In accordance with this definition, it consists of all financial intermediaries, organised and informal markets, payments and settlement networks, technical infrastructures supporting financial activity, legal and regulatory provisions, and supervisory agencies. This definition permits a complete view of the ways in which savings are channelled towards investment opportunities, how information is disseminated and processed, how risk is shared among economic agents, and how payments are facilitated across the economy.

The definition clearly has a systemic focus relating to the risk of spreading disturbances that could potentially jeopardise the core functions of the financial system; it does not deal with individual institutions, but with instances where real economic activities could be impaired. The reference to cumulative processes is meant to highlight the danger of spreading disturbances, which might be difficult to contain. In the presence of structural weaknesses in the financial system systemic problems could more easily arise.

The definition of financial stability is broader than banking stability. This does not, however, contradict the fact that banks play a crucial role in ensuring

25 Remarks by T. Padoa-Schioppa, Member of the Governing Council and the Executive Board of the ECB, at the TACIS High-Level Seminar in Moscow on 29 September 2004 entitled "The Role of Central Banks in Financial Stability Monitoring".

26 For other definitions of financial stability, see A. Houben, J. Kakes and G. Schinasi (2004).

Box 7.1 Why is financial stability gaining in importance?

According to the June 2004 IMF Working Paper entitled "Towards a Framework for Safeguarding Financial Stability"[1], financial stability is gaining in importance because:

"First, the financial system has expanded at a significantly faster pace than the real economy. In advanced economies, total financial assets now represent a multiple of annual economic production. Second, this process of financial deepening has been accompanied by a changing composition of the financial system, with an increasing share of nonmonetary assets and, by implication, greater leverage of the monetary base. Third, as a result of increasing cross-industry and cross-border integration, financial systems have become more interwoven, both nationally and internationally. Fourth, the financial system has become more complex, in terms of the intricacy of financial instruments, the diversity of activities, and the concomitant mobility of risks. [...] Although these trends reflect important advances in finance that have contributed substantively to economic efficiency, they evidently have implications for the nature of financial risks and vulnerabilities and the way these affect the real economy, as well for the role of policymakers in promoting financial stability. For instance, risk management and diversification techniques have, in principle, bolstered the resilience of the financial system, but the expansion of cross-sector and cross-border linkages implies more scope for contagion. Also, the surge in risk transfers has made it more difficult to track the development of risks. Monitoring efforts therefore need to be more intense, and policy responses generally require coordination among a larger number of authorities from a larger number of countries".

As such, the IMF Working Paper argues that looking at the safety and soundness of individual banks or at banking sector stability is insufficient in the modern world: attention should also be paid to the stability of the whole financial sector to ensure economic stability and growth.

1 A. Houben, J. Kakes and G. Schinasi (2004), "Towards a Framework for Safeguarding Financial Stability", IMF Working Paper, No 04/1001, International Capital Markets Department, June.

the soundness of the financial sector. In fact, macro-prudential analysis of the stability of the banking sector plays a pivotal role in the overall financial stability assessment in the EU, because the EU banking sector has a dominant position in the financial sector compared to bond issuance or other market-based financing of investments.

HOW CAN FINANCIAL STABILITY BE ANALYSED AND MONITORED?

The above IMF Working Paper contributes to the development of a framework for safeguarding financial stability and proposes the monitoring and analysis of four elements; a) macroeconomic conditions; b) financial markets; c) financial institutions; and d) the financial infrastructure.

More specifically, the framework proposes three possible results in the assessment process:

– *The financial system may be assessed to be broadly in the range of stability and likely to remain so in the near future*. In this case, the appropriate policy to be pursued by the responsible authority is mainly preventive, aimed at maintaining stability by relying on both private sector market-disciplining mechanisms and official supervision and surveillance. Communication can play a major role in this respect.

– *The financial system may be within a corridor of stability but moving towards its boundary*, for instance because imbalances are starting to develop, or because of changes outside the financial system. Safeguarding the stability of the system may then call for remedial action, for instance through moral suasion or more intensive supervision.

– *The financial system may be unstable*, i.e. outside the corridor of financial stability and therefore unable to perform an efficient allocation of resources between activities and across time, or to assess and manage financial risks as well as absorb shocks. In that case, policies should be "reactive" and aimed at restoring stability, which may include crisis resolution.

In December 2004, the ECB published its first Financial Stability Review, which can be downloaded from its website (www.ecb.int). The ECB will publish this Review regularly, just as many other central banks and supervisors in the EU publish regular (annual or semi-annual) financial stability reports. Frontrunners in this respect were the Bank of England and Sveriges Riksbank. In contrast to reports by national central banks and supervisors, the ECB's report looks at the whole euro area as opposed to a national banking system. The ECB's analytical approach takes a slightly different avenue compared to the one mentioned above in producing a comprehensive picture of the stability of the financial system. The ECB approach includes three steps. In the foreword, President Trichet writes: "The first entails forming an assessment of the individual and collective robustness of the institutions, markets and infrastructures that make up the financial system. The second involves an identification of the main sources of risk and vulnerabilities that could pose challenges for financial system stability in the future. The third and final step is an appraisal of the ability of the financial system to cope with crisis, should these risks materialise. The overall assessment will determine whether remedial action is needed. It is important to bear in mind that calling attention to the main sources of risk and vulnerability to financial stability does not aim at identifying the range of most probable outcomes such as that which underlies the monetary policy process. Rather it entails the highlighting of potential and plausible sources of negative events, even if these are remote and very unlikely." The structure of the ECB's 2004 Financial Stability Review reflects the pursuit of this framework. The report identifies key risks to the stability of the euro area financial system.

These include risks related to both the global and euro area economies as well as possible internal fragilities generated by different financial market players. The report then proceeds to analyse the impact of the realisation of these risks on the stability of the euro area financial system with special emphasis on banks owing to their systemic importance. The Financial Stability Review also includes chapters on topical issues.

WHICH ELEMENTS SHOULD BE CONSIDERED IN FINANCIAL STABILITY MONITORING?

Micro-prudential analysis focuses on the financial condition of an individual institution and the adequacy of risk management systems, and typically assesses the institution against a peer group of comparable institutions. Micro-prudential analysis is an important element in the work of a bank supervisor and is often performed using so-called early warning systems that allow the identification of outliers and hence whether special attention needs to be paid to individual institutions. The financial strength of individual institutions is an important element in the assessment of financial stability, and micro-prudential analysis therefore makes an important contribution to financial stability analysis.

Macro-prudential analysis complements micro-prudential analysis by including macroeconomic and financial market conditions that in micro-prudential analysis are taken as given for the individual company. Macro-prudential analysis further looks at the impact of various shocks or contagion effects arising from macroeconomic, financial markets or idiosyncratic events in specific financial institutions, in addition to the emphasis of micro-prudential analysis on relative or cross-sector risk assessment as well as time or cyclical variation in risk.

Both micro-prudential and macro-prudential analysis aim at maintaining financial stability; they are complementary and are today seen as equally important in financial stability monitoring.

Exhibit 7.1 The full set of macro-prudential indicators monitored by the ECB[1)]

I INTERNAL FACTORS

1. Profitability, balance sheet quality and capital adequacy

Income – cost developments and profitability

Income composition

Net interest income per operating income
Income from securities (dividends) per total operating income
Net non-interest income per total operating income
Commissions (net) and fees per total operating income
Trading and forex results per total operating income
Other operating income per total operating income

1) Additional information on the macro-prudential framework of the ESCB can be found in L. Mörttinen, P. Poloni, P. Sandars and J. Vesala (2005), "Analysing Banking Sector Conditions - How to Use Macro-prudential Indicators", ECB Occasional Paper, No 26, April. It can be downloaded from the ECB's website (www.ecb.int).

Exhibit 7.1 (cont'd)

Cost composition
Staff costs per total costs
Other administrative expenses per total costs
Other operating charges (excl. value adjustments and specific taxes) per total costs
Value adjustments and specific taxes per total costs

Efficiency
Operating cost (excl. value adjustments and specific taxes) per total operating income
Number of banks with cost-to-income ratio above 80%
Asset share of banks with cost-to-income ratio above 80%
Range of cost-to-income ratio

Profitability indicators
Profits II (after provisions, before tax and extraordinary items) per own funds (ROE II)
Profits II (after provisions, before tax and extraordinary items) per total assets (ROA II)
Profits III (after provisions, tax and extraordinary items) per own funds (ROE III)
Profits III (after provisions, tax and extraordinary items) per total assets (ROA III)
Distribution of ROE III: number of banks in each ROE category
Distribution of ROE III: share of assets of banks in each ROE category
Number of banks below ROE III of 5%
Share of banks below ROE III of 5% in total assets
Endowment effect as % of total profit before tax
Income and costs as percent of total assets
Net interest income per total assets
Interest receivable per total assets
Interest payable per total assets
Net non-interest income per total assets
Commissions and fees per total assets
Trading and forex results per total assets
Other operating income per total assets
Staff costs per total assets
Other administrative expenses per total assets
Other operating charges (excl. value adjustments and specific taxes) per total assets
Total operating expenses per total assets
Net value adjustments per total assets
Fund for general banking risks per total assets
Extraordinary profit or loss per total assets
Tax charges per total assets

Balance sheet

Coverage:
Total assets of the banking sector
Total assets of the reporting institutions per total assets of the banking sector

Asset composition
Cash and balances per total assets
Teasury bills per total assets
Loans and advances to credit institutions per total assets
Loans and advances to customers per total assets
Debt securities per total assets
Shares and participating interests per total assets

Liability composition
Amounts owed to credit institutions per total assets
Amounts owed to customers (deposits) per total assets
Debts evidenced by certificates per total assets
Funds for general banking risks per total assets
Provisions (stock) per total assets
Subordinated liabilities per total assets
Equity capital per total assets

Exhibit 7.1 (cont'd)

Off-balance sheet items
Contingent liabilities
Commitments
Derivatives (market values)

Capital adequacy
Total capital ratio
Tier 1 capital ratio
Own funds requirement under CAD (trading book)
Risk-weighted balance sheet items
Risk-weighted off-balance sheet items
Number of banks with risk based capital ratio below 9%
Share of banks with risk based capital ratio below 9% in total assets
Distribution of risk-based capital ratio: number of banks in each category
Distribution of risk-based capital ratio: share of risk weighted assets of banks in each category
Distribution of tier I ratio: number of banks in each category

Asset quality
Total non-performing and doubtful loans (net of provisions) per total loans and advances
Total non-performing and doubtful loans (net of provisions) per total own funds
Range of non-performing and doubtful loans (net of provisions) per capital
Range of non-performing and doubtful loans (net of provisions) per total loans and advances
Provisioning (stock) per total non performing and doubtful loans

Flow of provisions
Net value adjustments and fund for general banking risks (provisioning) per own funds
Net value adjustments and fund for general banking risks (provisioning) per total operating income
Net value adjustments and fund for general banking risks (provisioning) per loans and advances

2. Demand and supply (competitive) conditions

Interest receivable per total loans and advances, treasury bills and debt securities
Interest payable per amounts owed to credit institutions, customers (deposits), debts evidenced by certificate and subordinated liabilities
Average margin on new lending
Average margin on new lending to households
Average margin on new lending to non-bank corporations
Average margin on retail deposits
Overall margin

3. Risk concentrations

Credit growth and sectoral concentration
Aggregate lending
Total lending
Loans to residents
Loans to other MUMs
Loans to the rest of the world

Aggregate new lending
Total lending
Loans to residents
Loans to other MUMs
Loans to the rest of the world

Lending to non-MFI private sectors
Total lending
Loans to residents
Loans to other MUMs
Loans to the rest of the world
Lending to households
Lending to non-bank non-financial corporations
Lending to non-bank financial corporations
Residential mortgage lending to households
Commercial mortgage lending

Industry exposures
Exposure to construction

Exhibit 7.1 (cont'd)

Exposure to real estate
Exposure to TMT
Exposure to Tourism
Exposure to Energy
Exposure to Airline
Exposure to Insurance

Composition of other assets

Aggregate fixed income securities holdings
Total
Issued by residents
Issued by other MUMs
Issued by rest of the world

Aggregate equity holdings
Total
Issued by residents
Issued by other MUMs
Issued by rest of the world

Aggregate balance sheet
Total
Claims on residents
Claims on other MUMs
Claims on rest of the world

Currency and maturity structure of domestic lending
Share of less than one year lending to non-MFIs
Share of lending in foreign currency

Global credit exposures
Aggregate lending to non-bank customers
Aggregate securities holdings
Aggregate balance sheet total
Aggregate credit equivalent of off-balance sheet items

Liquidity risk
Ratio of non-bank deposits to M2
Ratio of total loans to non-bank deposits
Share of foreign short-term liabilities
Spread between the unsecured deposit rate and EONIA swap rate
Spread between the unsecured deposit rate and secured repo rate
Ratio of liquid assets to total assets

Exposures of EU15 to new EU member countries
Aggregate gross credit exposure to central and eastern Europe

Exposures towards emerging and developing countries
Aggregate total gross credit exposure
Aggregate gross credit exposure to Asian countries
Aggregate gross credit exposure to Latin American countries

Market risk exposures
Value-at-risk (VaR)
Interest rate VaR
Equity VaR
Ratio of VaR to Tier I

4. Market assessment of risks

All bank share price index vs. all share price index
Average yield spread between bank bonds and government bonds
Average yield spread between interbank CDs and treasury bills
Range of spreads between bank bonds and government bonds
Number of bank rating downgrades within the observation period
Distance to default of major EU banks
Credit default swap spreads
Range of interbank and CD rates

II EXTERNAL FACTORS

5. Financial fragility

Aggregate total debt to equity ratio in the (non-bank) corporate sector
Ratio of household total debt to household financial (and real) assets
Household savings ratio
Ratio of corporate debt servicing payments to corporate net earnings
Ratio of private households' debt servicing costs to disposable income
Number of arrears
Number of bankruptcies

Exhibit 7.1 (cont'd)

Median expected default frequencies (EDFs) for key industries
Basic goods and construction (BaC)
Consumer cyclicals (Ccy)
Consumer non-cyclicals (CNC)
Capital goods (Cap)
Financial (Fin)
Technology and telecommunications (TMT)
Energy and utilities (EnU)
Residual category (Oth)

6. Asset price developments

General stock index
Euro STOXX index
US stock index
Commercial real estate prices
Residential real estate prices

7. Cyclical and monetary conditions

Rate of real GDP growth
Rate of nominal GDP growth
Rate of growth in real aggregate investment
Rate of growth in real private consumption
Rate of growth of unemployment rate
Rate of change in M2
Rate of change in the money market interest rate (3 month)
Rate of change of long-term real interest rate (10 yr. govt. bond)
Rate of change in the exchange rates (EUR, DKK, GBP, GRD and SEK)
Rate of change in the consumer price index

III CONTAGION FACTORS

8. Interbank markets

Share of interbank liabilities in total liabilities
Share of assets of the three banks with largest exposures (separately for each counterparty country) vis-à-vis total banking sector assets
Share of assets of the five banks with largest exposures (separately for each counterparty country) vis-à-vis total banking sector assets

Financial stability analysis can be divided into a mostly backward-looking analysis of the condition of the financial and non-financial sector and cumulated risk exposures and a forward-looking part, which aims at capturing the possible risk scenarios and their likelihood as well as the developments in financial markets and institutions in the near to medium term. Data typically used for micro-prudential analysis are very useful for the backward-looking assessment of the current conditions in the financial system. In the ECB framework, this includes analysis of the income statement (income-generating ability, efficiency and profitability), capital adequacy (the size of the buffers) and the balance sheet (asset quality and liquidity). These indicators provide a view on how the banking system has performed under past economic and financial market conditions. Data need to be timely, of high quality and comprehensive to support quantitative analysis. In addition, supervisors can provide additional input on the qualitative side, and the analytical process must be backed by sufficient staff with adequate qualifications.

Box 7.2 Indicators recommended by the IMF for assessment of current conditions in the financial sector[5]

Capital-based indicators:
– Regulatory capital to risk-weighted assets (core)
– Regulatory tier 1 capital to risk-weighted assets (core)
– Capital to assets
– Return on equity (net income to average capital [equity]) (core)
– Non-performing loans net of provisions to capital (core)
– Large exposures to capital (core)
– Duration of assets and liabilities (core)
– Net open positions in foreign exchange to capital (core)
– Gross assets and liabilities position in financial derivatives to capital
– Net open position in equities to capital
Asset-based indicators:
– Liquid assets to total assets (liquid asset ratio) (core)
– Liquid assets to short-term liabilities (core)
– Customer deposits to total (non-interbank) loans
– Return on assets (net income to average total assets) (core)
– Non-performing loans to total gross loans (core)
– Sectoral distribution of loans to total loans (core)
– Residential real estate loans to total loans
– Commercial real estate loans to total loans
– Geographic distribution of loans to total loans
– Foreign currency-denominated loans to total loans
– Foreign currency-denominated liabilities to total liabilities
Income and expense-based indicators:
– Interest margin to gross income (core)
– Trading and foreign exchange gains (losses) to [gross] total income
– Non-interest [operating] expenses to gross income (core)
– Personnel expenses to non-interest expenses

1 The IMF has published a guide on financial soundness indicators; this set is used by an increasing number of central banks and supervisors around the world.

Turning to the identification of sources of risk, for credit risk the ECB framework includes for instance balance sheet indicators for credit growth, funding conditions and exposures by country, sector and industry. Useful indicators for evaluating how competitive conditions are in the banking sector include the pricing of credit risk, credit growth rates and lending, deposit and overall margins. They also allow monitoring of a possible danger that risk premiums could be cut to gain market share, which may create major fragilities in the system because of an inadequate pricing of risk, whereby income is insufficient to cover future losses. Another element in the identification of sources of risk is a set of indicators on the financial condition of borrower sectors. Indebtedness data, payment arrears and bankruptcy information are useful for this analysis. In addition, unemployment data as well as GDP growth forecasts are necessary for

the forward-looking assessment. Forward-looking industry-specific indicators, such as expected default frequencies, are also often used in conjunction with exposure data to draw conclusions on exposures at risk. For households, core indicators of possible fragilities relate to lending for house purchase, the total indebtedness of households, loan servicing costs, fixed versus floating rate loan breakdowns, and loan-to-value ratios. The potential market fragility is assessed against information on housing price developments.

A number of external factors or occurrences can also be a source of risk for financial stability, such as major adverse developments in the economy, adverse developments in financial markets, fragilities in other financial institutions, fragilities in the non-financial sector, and major external shocks (9/11, war, etc.).

Another set of indicators that stems from the markets can be used in the forward-looking analysis to assess the financial system's ability to withstand risks. There are a number of alternatives to choose from, but the basic idea is to look for indications that financial markets, when trading in bonds or equities issued by banks, require higher relative margins vis-à-vis safe rates which could signal increasing risks.[27]

HOW CAN MACRO STRESS-TESTING CONTRIBUTE TO FINANCIAL STABILITY MONITORING?

Finally, macro stress-testing is evolving as a tool for analysing the ability of the system to withstand shocks/risks. This type of testing is usually built around different scenarios. A distinction needs to be drawn between those scenarios that can be considered "baseline" (i.e. high likelihood of occurrences but not necessarily very strong implications for the system) and those that are clearly stress scenarios (i.e. drastic events which are less likely but may generate severe market turbulences and large losses for financial institutions). A relevant question in terms of assessing banking stability could be how much a bank could lose in terms of capital and other buffers should a stress scenario occur. The question can also be posed in another way, such as whether there are any possible events that could cause banks to lose more than a predefined threshold of required capital and buffers.

One way of creating a stress scenario is to look at major historical events, such as major drops in stock markets (Black Monday in October 1997, or the bursting of the IT/telecom stock market bubble in 2000), wars that have a direct impact on oil prices (e.g. the first Gulf War in January 1990), or a terrorist attack (the World Trade Center on 11 September 2001). As historical events may not adequately capture the most important risks in the current environment, it is useful to complement the analysis with hypothetical events. The underlying model simulates what happens to banks' balance sheets and performance

27 Relevant literature in this field includes for instance R. Gropp, J. Vesala and G. Vulpes (2002), "Equity and Bond Market Signals as Leading Indicators of Bank Fragility", ECB Working Paper, No 150, June.

should the historical event repeat itself or a hypothetical example materialise. In designing the scenarios, it is important to make sure – e.g. with the help of a macroeconomic model – that they are plausible in the sense that changes in different variables are consistent with each other. This type of analysis requires time series of relevant micro-prudential and macro-prudential indicators.

8 BANKING SUPERVISION PRINCIPLES AND FRAMEWORK IN RUSSIA*

8.1 RISKS TO WHICH RUSSIAN BANKS ARE EXPOSED AND THEIR SPECIFIC FEATURES

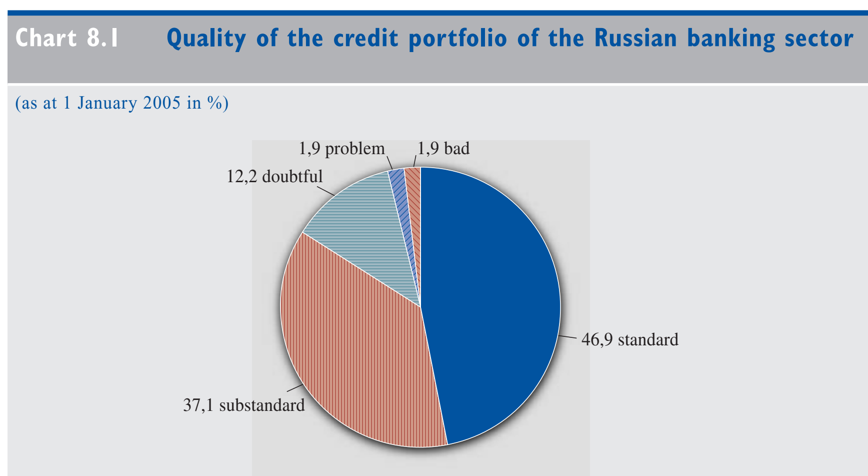
Credit risk. Credit risk in Russia, as in most other countries, is the most significant risk incurred by credit institutions. The recent rapid growth in credit has led to higher credit risk in the banking sector.

The widespread practice of connected lending is aggravating the problem of credit risk concentration. Banks often lend money to borrowers that are independent in formal (legal) terms, but have, nevertheless, economic links between them. This leads to significant growth of the actual credit risk concentration level, including risk concentration by economic sector. A lack of transparency of borrowers complicates the identification of such connections.

The share of non-performing loans (problem loans and bad loans) in the overall number of loans is moderate today (see Chart 8.1).

Chart 8.1 Quality of the credit portfolio of the Russian banking sector

(as at 1 January 2005 in %)

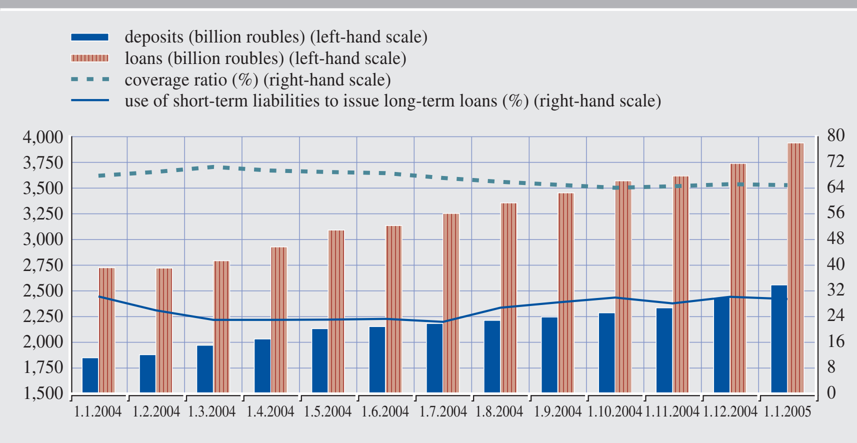


The expansion of lending to the non-financial sector makes the quality of banks' credit portfolios more dependent on the financial condition of the borrowers. The assessment of their financial condition is carried out, inter alia, by the Bank of Russia within the framework of its monitoring of corporate borrowers. Overall in 2004 this monitoring did not detect any additional signs of a deterioration in banks' credit portfolios.

A factor limiting the development of credit operations and increasing risks is insufficient transparency of borrowers. However, the risks relating to credit operations will be mitigated by the establishment of credit history bureaus.

* Editor of Chapter 8: A. Kozlov, First Deputy Chairman of the Bank of Russia.

Chart 8.2 **Gap between loan amounts and principal sources of funding at Russian banks**



Liquidity risk. The shortage of medium- and long-term resources is an important factor hindering the development of banks' operations. Continuing maturity mismatch between credit institutions' assets and liabilities is having a direct, adverse impact on the liquidity level of the banking sector.

There is a growing gap between the amount of loans granted to customers (excluding interbank loans) and the deposits received from them (see Chart 8.2).

The percentage of loans funded from other sources is growing. These other sources include the interbank market and balances on the current accounts and settlement accounts of corporate customers, which are mainly of a short-term nature. This is evidence of the potential risk that some credit institutions may encounter in fulfilling their obligations to their clients in case of possible unfavourable changes in the financial markets.

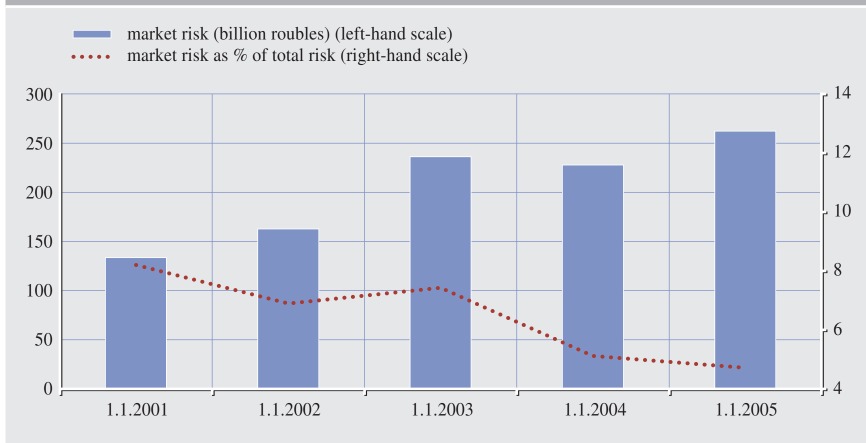
At the same time, the long-term resource base of credit institutions has been growing in recent years, in particular medium- and long-term (over one year) personal deposits. These have increased 6.8 times since 2002. In early 2005, over half of the overall amount of deposits were medium- and long-term deposits.

Market risk. Despite the growth of market risk, its share in the total risk of the banking sector is still low at about 5% (see Chart 8.3).

The structure of market risk has undergone significant changes over the recent five-year period[28]: whereas on 1 April 2000 the predominant component of total market risk was currency risk (accounting for over 95%), today equity risk is the most important one for credit institutions. The reason for this is the greater involvement of credit institutions in stock market trading operations.

28 The Bank of Russia Regulation stipulating the procedures for the estimation of market risks by credit institutions became effective on 1 April 2000.

Chart 8.3 **Share of market risk in the total risk of the Russian banking sector (%)**



Significant changes in the Russian market risk structure were also observed in 2004. In the period January-November 2004, the single most important component was equity risk, but the situation changed in December and the beginning of 2005 with interest rate risk coming to the fore within the overall market risk for the first time (its percentage share rose from 32.3% to 41.8% in 2004). The shares of equity and currency risks declined in 2004 from 40.3% to 39.8% and from 27.4% to 18.3%, respectively.

Currency risk. The Bank of Russia regulates currency risk not only as a component of market risk to be covered by banks' own funds (capital), but also by limiting its amount. The open currency position limits set by the Bank of Russia are determined as a ratio between open positions in foreign currencies and precious metals and own funds of credit institutions.

The following limits are currently effective: 10% for individual foreign currencies and/or precious metals and 20% for the total amount of open currency positions. Importantly, open currency positions not only include positions in foreign currencies and precious metals, but also rouble positions where the amount depends on changes in foreign currencies' exchange rates against the rouble.

Interest rate risk. Interest rate risk, or interest risk, is a fundamental banking risk that arises on financial instruments which are not included in the credit institutions' trading portfolio.

Interest rate risk results from a maturity mismatch between assets and liabilities, off-balance-sheet claims and obligations of the credit institution (for instruments with fixed interest rates), or from a mismatch in the timing of the readjustment of interest rates (for instruments with floating interest rates).

The Bank of Russia is currently developing recommendations for credit institutions regarding interest rate risk management and calculation methods.

Operational risk. At present, the Bank of Russia has no regulations for banks to assess operational risk or calculate capital coverage. The possibility of any standards being issued to regulate operational risk largely depends on the compilation of data series for a number of years. Obviously, with the expansion of banking business and development of banking technologies, credit institutions' exposure to operational risks, including IT and legal risks, will grow.

The recommendations for the management of operational risk in credit institutions developed by the Bank of Russia are a first step towards calculating regulatory capital to cover operational risk in Russia. Recommendations on the management of legal risk and reputational risk will soon follow.

An important factor in making the Russian banking sector more stable and in reducing the level of risk within the sector was the introduction in 2004 and 2005 of a deposit insurance scheme under the Federal Law "On the insurance of household deposits in banks of the Russian Federation." The principal aims of the deposit insurance scheme are to protect the rights and legal interests of depositors in Russian banks, enhance their confidence in the banking system and create incentives for individuals to deposit their savings with the banking sector.

8.2 BANKING REGULATION AND SUPERVISION IN RUSSIA: GENERAL ISSUES

ORGANISATIONAL STRUCTURE OF BANKING REGULATION AND SUPERVISION IN RUSSIA

Under the Federal Law "On the Central Bank of the Russian Federation (Bank of Russia)," the Bank of Russia, as the banking regulator and supervisor, is responsible for maintaining the stability of the banking system of the Russian Federation and protecting the interests of lenders and depositors.

The regulatory and supervisory functions of the Bank of Russia under this Federal Law are exercised through a permanent body, the Banking Supervision Committee, which brings together the structural units of the Bank of Russia responsible for the implementation of its supervisory functions.

The structure of the Banking Supervision Committee is approved by the Board of Directors of the Bank of Russia. The Chairman of the Banking Supervision Committee is appointed by the Chairman of the Bank of Russia from among the members of its Board of Directors. The Chairman of the Bank of Russia, upon the recommendation of the Chairman of the Banking Supervision Committee, appoints Deputy Chairmen of the Committee, particularly from among the

heads of the structural units of the Bank of Russia which perform supervisory functions.

The following structural units of the Bank of Russia are currently members of the Banking Supervision Committee:

– The Banking Regulation and Supervision Department

– The Credit Institutions Licensing and Financial Rehabilitation Department

– The Financial Monitoring and Currency Control Department

– The Legal Department

– The Credit Institutions Chief Inspectorate

– The Central Agency for Information Security and Protection

– The Regional Branch of the Central Bank of the Russian Federation for the City of Moscow

The Banking Supervision Committee is responsible for the preparation of decisions regarding the implementation of the banking regulation and supervision policy of the Bank of Russia.

The main task of the member units of the Banking Supervision Committee is to provide methodological and organisational support to the statutory functions of the Bank of Russia in the banking regulation and supervision sphere. Its activities cover the whole "supervision cycle": from the licensing of credit institutions, ongoing supervision of their business and on-site inspections, to financial rehabilitation and, if required, liquidation of financially unstable credit institutions.

The Bank of Russia's policy in the field of regulation and supervision of credit institutions is implemented through its territorial units in constituents of the Russian Federation (national banks and regional branches). As at 1 January 2005, the system of the Bank of Russia comprised 19 national banks and 59 regional branches.

IMPLEMENTATION OF THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION IN RUSSIA. LEGAL FRAMEWORK FOR BANKING REGULATION AND SUPERVISION

In its function as a banking regulator, the Bank of Russia is guided by the best practices in international banking regulation and supervision and, above all, the Basel Committee on Banking Supervision's Core Principles for Effective

Banking Supervision. In the opinion of experts of the International Monetary Fund and the World Bank, the existing regulatory system of the Russian banking sector conforms, to a considerable extent, to the Basel Principles.[29]

The consolidated results of the assessment performed by international experts within the Financial Sector Assessment Program, according to the traditional compliance classification, were as follows:

COMPLIANT:
Principle 1 "Objectives, independence, powers and resources" as regards "Legal framework" and "Legal protection"; Principle 2 "Permissible activities"; Principle 4 "Ownership interests".

LARGELY COMPLIANT:
Principle 1 "Objectives, independence, powers and resources" as regards "Objectives", "Independence" and "Powers to address compliance"; Principle 5 "Investment criteria"; Principle 6 "Capital adequacy"; Principle 7 "Loan granting policy"; Principle 8 "Asset quality assessment and loan loss provisions and loan loss reserves"; Principle 9 "Limits to restrict exposures"; Principle 11 "Country risk"; Principle 12 "Market risks"; Principle 13 "Other material risks"; Principle 14 "Internal control and audit"; Principle 18 "Off-site supervision"; Principle 22 "Corrective action".

MATERIALY NON-COMPLIANT:
Principle 1 "Objectives, independence, powers and resources" as regards "Information sharing"; Principle 3 "Licensing criteria"; Principle 10 "Connected lending"; Principle 15 "Money laundering"; Principle 16 "On-site and off-site supervision"; Principle 17 "Contacts with management of banks"; Principle 19 "Validation of supervisory information"; Principle 21 "Accounting policies and practices"; Principle 23 "Global consolidated supervision"; Principle 24 "Host country supervision"; Principle 25 "Supervision of foreign bank operations".

NON COMPLIANT:
Principle 20 "Consolidated supervision".

In order to achieve further convergence of the Russian domestic prudential requirements with the Basel Principles, the Bank of Russia is carrying out a determined and large-scale campaign to improve the regulatory framework for banking regulation and supervision.

In the field of bank registration (authorisation) and licensing, stricter requirements are being applied to the founders (members) of credit institutions as

29 In 2002-03, the Bank of Russia took part in the Financial Sector Assessment Program implemented by the International Monetary Fund and the World Bank, which included, among other things, analysis of compliance of the legislative and regulatory framework of the Russian banking regulation and supervision system with the Basel Principles.

regards the transparency of the founders (members) and/or their group structure when incorporating a new credit institution, expanding a credit institution's business, changing the legal status of a credit institution or reorganising it.

The Bank of Russia has issued a Regulation setting the requirements for the content of business plans prepared by credit institutions. In addition, guidelines have been developed to assess the financial condition of corporate founders (members) of credit institutions.

Procedures have been introduced for keeping and disclosing records of persons connected with credit institutions. Furthermore, the procedures for the reorganisation of credit institutions through mergers and takeovers have been simplified. In addition, the Bank of Russia has clarified the criteria for assigning legal entities and/or individuals to the category of contractually connected persons.

In the area of off-site supervision, the Bank of Russia aims at proactive banking supervision. This includes using more advanced methods to assess the risks and financial stability of credit institutions, determining the most efficient banking supervision regimes, moving towards consolidated supervision and developing an early warning system based on the off-site analysis of data. In order to achieve the above-mentioned goals, increasing prominence is being given to motivated professional judgement of the supervisor.

The new version of the Regulation of the Bank of Russia on mandatory limits for banks stipulates, among other things, that credit institutions must comply with mandatory limits on a daily basis. This has helped to eliminate the practice formerly employed by some credit institutions of carrying out "adjusting" operations to achieve formal compliance with the mandatory limits on reporting dates.

A Bank of Russia Regulation stipulating additional prudential requirements for credit institutions issuing mortgage-secured bonds has entered into force.

Regulations of the Bank of Russia on provisioning for possible losses are expanding the scope of application of the professional judgement principle in assessing the quality of loans (credit claims), based primarily on the borrower's financial position and its debt-servicing ability.

The Bank of Russia has approved important regulations aimed at improving the quality of bank capital, under which the own funds generated by investors using ineligible assets should be deducted from capital (where ineligible assets are understood to be funds and/or other property received, directly or indirectly through third parties, belonging to the credit institution itself, and/or property provided by others, if the credit institution has undertaken, directly or indirectly through third parties, the risk of losses arising from making such property available).

Lending to connected parties often occurs on non-market terms and involves higher risk, leading to greater losses on the part of banks. The Bank of Russia has no legislative powers today to regulate such risks. Therefore, the Bank of Russia has made recommendations to banks regarding additional control of the risks which arise from lending to parties connected to banks.

Efforts are continuing to establish "dedicated supervisors" (supervisory contact persons) of credit institutions. Experience shows that such a measure generally corresponds to a risk-oriented approach to supervision. The dedicated supervisor of the credit institution, working directly with its management and employees and having all the available information regarding its business, can evaluate adequately the current condition and future development of the credit institution, identify areas of higher risk in its operations and make proposals about the supervisory actions to be taken and the banking supervisory regime to be applied.

The institution of dedicated supervisors has been tried out in ten territorial branches of the Bank of Russia, with positive results.

At present, the Bank of Russia is finalising the methodological documentation needed to fully introduce dedicated supervisors of credit institutions into Russian supervisory practice. The documentation includes the Regulation of the Bank of Russia on dedicated supervisors of credit institutions and the Methodological Manual for dedicated supervisors ("The Dedicated Supervisor Manual").

The Regulation of the Bank of Russia on internal control functions in credit institutions and bank groups follows the new, principle-based approach to prudential regulation.

In the field of on-site supervision (inspection of credit institutions), a group of General Inspectors has been formed, to be responsible for the coordination of the inspection activities of the territorial branches of the Bank of Russia within respective federal districts.

A Bank of Russia Regulation has been issued on the procedures for the inspection of credit institutions (or their branches) by authorised representatives of the Bank of Russia, providing for a shift of emphasis towards a qualitative assessment of the operations of credit institutions (or their branches) based on professional judgements of supervisors concerning the risk management systems, organisation of internal control, financial condition and future prospects of credit institutions.

In the area of financial rehabilitation and liquidation of credit institutions, regulations of the Bank of Russia on financial rehabilitation and liquidation of credit institutions have been developed in keeping with the Supervisory Guidance on Dealing with Weak Banks issued by the Basel Committee on Banking Supervision.

The Bank of Russia has issued a definition of “material lack of reliability of reporting data”, which allows the identification of instances of unreliable reporting, in which case the credit institution is subject to revocation of its banking licence.

LEGAL FRAMEWORK FOR BANKING REGULATION AND SUPERVISION

For banking business to develop, an adequate supervisory framework and tools are necessary. However, despite the undeniable progress achieved in recent years in the field of banking legislation, the legal foundation of banking regulation and supervision in Russia is still far from perfect and requires further serious improvement, both in the form of statutory legislation and Bank of Russia regulations.

The most important principle for improving the banking regulation and supervision system is the application of internationally recognised standards and international experience, with due regard for the specific features of the Russian banking market in terms of organisation and functioning. This requires considerable development by the Bank of Russia of risk-oriented approaches to supervision. For this purpose, laws empowering the Bank of Russia to exercise motivated professional judgement in its supervisory practice are necessary.

One of the characteristic features of the Russian banking sector is its insufficient capitalisation. An important measure which would motivate banks’ owners to build up their capital base and maintain bank equity at an adequate level is the implementation of stricter requirements with regard to capital adequacy. Failure to satisfy these requirements would be considered as a justification for the mandatory revocation of a banking licence. In order to attract foreign capital, the procedure for the acquisition of large shareholdings in Russian credit institutions must be similar for residents and non-residents.

Further improvement is required in the legal framework for consolidated supervision, including the preparation of consolidated statements and the calculation, on the basis of these statements, of consolidated risks.

The rapid development of remote banking services, including e-banking, calls for legal regulation of such activities and for prudential limitation of related operational risks, including IT and legal risks.

One of the main reasons for the loss of stability by banks is poor management. Requirements should be raised significantly concerning owners and managers of credit institutions. It is necessary to prevent management of credit institutions from falling into the hands of managers and owners with a tainted reputation or an unstable financial position. Therefore, measures should be taken to guard against this during the process of registration and licensing of credit institutions.

Timely and efficient use of corrective action preventing insolvency (bankruptcy) of credit institutions will be promoted by amending the law to improve the credit institutions' liquidation procedures, including setting up an efficient mechanism for selling the assets of banks in liquidation and excluding impaired assets from the bankrupt debtor's estate.

In view of its supervisory role, the powers of the Bank of Russia to deal with administrative offences in the banking sphere need to be specified. Administrative responsibility of officers of credit institutions for weaknesses relating to the banking business should also be determined.

The Russian banking sector will achieve a maximum possible level of compliance with the international standards after it completes the third phase of its reform (2004 to 2008), and after the tasks set forth in the "Strategy for the development of the banking sector of the Russian Federation for the period until 2008" have been implemented.

DEVELOPMENT OF RISK-ORIENTED SUPERVISION OF RUSSIAN BANKS

The development of supervision implies moving away from assessing specific risks of credit institutions based on the extent of their compliance with the prudential limits set by the Bank of Russia, and towards assessing their risks on the basis of the supervisor's professional judgement regarding the quality of assets, liabilities and own funds of credit institutions, together with the quality of their management and internal control systems. The professional judgement should be based on the results of a comprehensive analysis of credit institutions' business and a review of their development strategy, own funds, ownership and management structures, and internal documents regulating their internal control functions and risk management procedures.

The use of such approaches assumes that supervision will be primarily aimed at:

– identifying the business lines of the bank involving the highest risks and/or the areas of the bank most exposed because of any faults in the management, control systems and/or other systems of the bank; and

– identifying weak banks and conducting closer supervision of their business relative to banks whose business is not causing any serious concern.

The above approaches were used by the Bank of Russia when assessing credit institutions for their compliance with the criteria for joining the deposit insurance scheme. The Federal Law "On the insurance of household deposits in banks of the Russian Federation," as well as Instruction No 1379-U of the Bank of Russia of 16 January 2004 "On the assessment of a bank's financial stability in order to consider it eligible for participation in the deposit insurance scheme" based on the aforementioned Law, provide that, in order to assess a bank's business,

not only the financial indicators of the bank are to be used, but also indicators characterising the quality of the bank's management, its operations and risks, including the transparency of its ownership structure, its risk management system and the internal control function. The financial indicators used for the assessment are supplemented by the indicators of the profitability of the bank's business. Methods for the assessment of credit institutions' financial soundness are still being developed.

Prudential reporting forms are being improved within the framework of the EU/TACIS Project on Banking Supervision and Reporting.

To facilitate the transition to risk-oriented supervision, the Bank of Russia is working on, or intends to work on, the following:

– An early warning system (EWS) based on the credit institution scenario method and the application of this system in the supervisory practice. The basic EWS model selected by the Bank of Russia is a model which forecasts (for a period of up to six months) potential changes in the capital adequacy indicator by using the modified linear regression method. In order to implement it, relevant software has been developed.

– The improvement of consolidated supervision, including the analysis of risks undertaken by credit institutions in their relations with individuals and legal entities, including with non-credit institutions which are members of banking groups and bank holding companies.

The development of risk-oriented supervision will be promoted by introducing in Russia dedicated supervisors of credit institutions, since only everyday contact between the bank and the supervisor will make the latter properly aware of the processes within the credit institution. Such a dedicated supervisor, as the principal supervisory point of contact with the credit institution, its management and employees, accumulates full information concerning its business, thus allowing for integrated and almost real-time supervision, and also for a timely response, when necessary, to the processes taking place within the bank.

The development of the risk-oriented component of supervisory activities should have proper legislative foundations. The Bank of Russia should have the legal right to assess credit institutions' activities and take supervisory decisions based on professional judgement regarding the quality and value of their assets, liabilities and own funds (capital), as well as regarding credit institutions' corporate governance quality, including their management and risk control systems, and the transparency of their ownership structure.

FUTURE IMPLEMENTATION OF BASEL II IN RUSSIA

The Basel II Agreement ("International Convergence of Capital Measurement and Capital Standards: a Revised Framework") is a comprehensive document including three components (known as pillars):

- *Approaches to capital adequacy calculation* (Minimum Capital Requirements, Pillar 1). The first component provides for several alternative methods for the calculation of capital adequacy to cover credit, market and operational risk. These alternatives, intended for different levels of financial market and risk management development, allow banking supervision authorities and banks to select the approaches best corresponding to the nature of the banks' operations and the infrastructure of the national markets. Basel II gives supervisory authorities a degree of freedom in the application of the chosen approach, thus making it possible to adapt the standards to the different conditions of the national markets.

- *Procedures for supervision of the capital adequacy of banks by the banking supervision authorities depending on the nature of risks undertaken by banks and the quality of their internal risk assessment systems* (Supervisory Review Process, Pillar 2). Based on the assessment of the nature and amount of risks incurred by a bank, and also on the adequacy of its risk management system, banking supervisors may require the bank to maintain its capital at a level higher than the minimum.

- *Requirements relating to the disclosure by banks of information regarding their capital and risks in order to enhance market discipline* (Market Discipline, Pillar 3).

Preconditions of Basel II implementation in Russia

In order to implement the new approaches to capital adequacy developed by the Basel Committee on Banking Supervision, the following preconditions must be met:

- a well-developed legal framework, including in the banking regulation and supervision sphere, to enable the implementation of Basel II's Pillars 2 and 3;

- a rather high level of economic stability;

- a highly developed general economic culture and banking culture; and

- availability of historical information on borrowers' creditworthiness for a number of years, at least covering a full economic cycle.

At the current juncture, full compliance with these criteria cannot even be found in fairly developed countries. Emerging markets are usually much farther from meeting these requirements.

Plans of the Bank of Russia regarding implementation of Basel II
The plans of the Bank of Russia regarding the implementation of Basel II, described in the press releases of 8 June and 22 July 2004, are as follows: implementation by 2008 or 2009 of the Simplified Standardised Approach to the assessment of credit risk and the Basic Indicator Approach to operational risk. Implementation of the IRB approach (the approach based on the internal rating systems of credit institutions) is possible in the medium term, after reliable credit risk databases are created and the quality of the banks' management improves, and taking into consideration the results of implementation of the approach in other countries, including the home countries of the foreign parents of Russian banks.

The Bank of Russia encourages the banking community to adopt the "advanced" approaches proposed by Basel II in order to promote a risk management culture and enhance market discipline. In this sense, Basel II is considered by the Bank of Russia not only as an authoritative set of recommendations for banking regulators and supervisors, but also as recommendations that apply directly to banks.

8.3 LICENSING OF CREDIT INSTITUTIONS

Under the Federal Law on the Central Bank of the Russian Federation, the competencies of the Bank of Russia include taking decisions regarding the authorisation of credit institutions, issuing banking licences to credit institutions, and suspending and revoking such licences in accordance with the procedures stipulated by the Federal Law "On banks and banking."

The *authorisation of credit institutions* is the responsibility of the Federal Tax Authority, following a decision of the Bank of Russia.

Both legal entities and individuals may be founders of a credit institution. Corporate founders must have existed for at least three years, they must have a stable financial position and adequate own funds for contribution to the authorised capital, and also must have made obligatory payments to budgets (have no tax arrears) over the preceding three-year period. Individual founders must have adequate own funds (property) to acquire shares (holdings) in the credit institution and satisfactory financial standing.

For authorisation purposes, founders of the credit institution must prepare founding documents, compile a business plan and equip the premises for handling valuables.

Founders must nominate the sole executive officer (and his/her deputies), members of the collective executive body and the chief accountant (and his/her deputies) of the credit institution from among persons having the following qualifications: a sound business reputation, a university degree in a related area (Law or Economics) and at least one year's experience of managing an operational division in a credit institution (in case of a higher education degree in an unrelated area, at least two years of such managerial experience are required).

The business reputation requirement is also applied to proposed members of the board of directors (supervisory board) of the credit institution.

Authorisation of a credit institution must be approved by the Federal Anti-monopoly Authority as regards the satisfaction of the anti-monopoly legislation requirements. Bank operations with precious metals require approval from the Ministry of Finance of the Russian Federation.

In order to prevent the banking system from being penetrated by dishonest persons capable of abusing the business of credit institutions, acquisition (by a person or a group of persons) of over 20% of shares (holdings) in a credit institution requires the prior approval of the Bank of Russia. Participation of non-residents in the authorised capital of a credit institution requires prior consent of the Bank of Russia, irrespective of the amount of acquired shares (holdings).

The minimum authorised capital of a newly established bank must not be less than €5 million, and €500,000 for a new non-banking credit institution. Any in-kind (property) contribution to the authorised capital of a credit institution must not exceed 20% of the authorised capital. The current requirement is that only a bank building (office) may be used as such a contribution. The authorised capital of a credit institution cannot be formed with borrowed funds.

If the credit institution is organised as a joint stock company, issuance of shares is required additionally.

After the authorisation of the credit institution and when its authorised capital has been fully paid up, the Bank of Russia may issue the following types of (unlimited) banking licences:

- for banks: a banking licence permitting operations with funds in roubles or in roubles and foreign currencies (without the right to take personal deposits); a banking licence to take deposits of precious metals and carry out operations with them;
- for non-banking credit institutions: licences listing banking operations according to their purpose.

EXPANSION OF THE BUSINESS OF A CREDIT INSTITUTION

An existing credit institution may expand its business by obtaining additional banking licences. For this purpose, it must be stable in financial terms, meet its obligations with regard to budgets, disclose information concerning its stakeholders (participants) and their groups (affiliated parties), have an adequate organisational structure and satisfy the fit and proper standards for members of the board of directors (supervisory board) and managers. A credit institution which applies for a General Licence must have own funds (capital) of at least €5 million.

In order for banks to expand their business, the following types of licences may be issued to them:

– a banking licence permitting operations with funds in roubles and foreign currencies (without the right to take personal deposits);

– a licence to take deposits of precious metals and carry out operations with them;

– a licence to take personal deposits in roubles or in roubles and foreign currencies;

– the General Licence.

The right to take personal deposits can only be granted to banks at least two years after the date of their authorisation. A bank granted such a right must join the deposit insurance scheme and be registered by the State Deposit Insurance Agency.

8.4 ONGOING SUPERVISION (OFF-SITE SUPERVISION AND INSPECTIONS)

Ongoing supervision (supervision of day-to-day activities of credit institutions) includes off-site supervision and on-site inspections. The strategic task of ongoing supervision is to ensure the proper quality of management of a credit institution, i.e. management which focuses on both internal and external aspects of the business of the credit institution and enables the institution to function as a going concern.

OFF-SITE SUPERVISION

Off-site supervision is the central component of ongoing supervision in the Russian Federation. Its purpose is to identify, as soon as possible through continuous monitoring of the credit institution's business, problems which may, in case of their aggravation, threaten the interests of its depositors and investors (lenders), undermine the solvency of the credit institution and, ultimately, lead to its bankruptcy. Off-site supervision also allows early corrective supervisory

action to overcome the negative developments and trends uncovered by the supervisors.

Off-site supervision of credit institutions in the Russian Federation is carried out by the territorial branches of the Bank of Russia at the credit institutions' premises.

SOURCES OF OFF-SITE SUPERVISORY INFORMATION

Sources of off-site supervisory information include:

- financial reporting of credit institutions (including consolidated financial statements of the banking/consolidated group or the bank holding company, where the credit institution is the parent institution or a member of the banking/consolidated group or the bank holding company);

- on-site inspection reports;

- information gathered during visits to the credit institution by supervisors or during meetings with the management (heads of units) of the credit institution, or information requested from the credit institution;

- internal documents of the credit institution on risk control procedures, on the organisation and functioning of the internal control system, business plans, etc.;

- auditor reports;

- mass media information, including electronic media information; and

- other sources of relevant information about the credit institution.

CREDIT INSTITUTIONS' ANALYSIS AND ASSESSMENT TOOLS

The supervisory units of the territorial branches of the Bank of Russia analyse the financial condition of the supervised credit institutions on a monthly basis. This analysis helps assess the financial soundness of the institution and determine whether there is a need for supervisory corrective action.

The Bank of Russia has a rather wide range of tools enabling adequate analysis and assessment of credit institutions. In particular, the analysis of the financial condition of credit institutions is performed in accordance with the recommendations (guidelines) endorsed by representatives of the IMF and implemented in the *Bank Financial Soundness Indicators* software. The analysis is based on the use of a system of indicators which characterises the operations of a bank and the types of risks it takes. The analysis identifies relations between indicators, reviews the dynamics of such indicators and the risks taken, and compares the indicators of the analysed credit institution with those for its peer group and the banking system as a whole. The analysis also reveals high-risk

areas in the bank's operations, determines the factors affecting changes in the types of risks taken and identifies the bank's problems at the earliest possible stage. It provides a reliable picture of the current financial condition of the bank, its current dynamics and projections for the coming year. Through it, the reports submitted by credit institutions to the Bank of Russia are also assessed for reliability.

The results of the assessment form the basis of the professional supervisory judgement as to the bank's financial soundness and the lines of its business which should be inspected by on-site supervisors.

The assessment of credit institutions' financial soundness is currently performed in accordance with the Instruction No 766-U of the Bank of Russia of 31 March 2000 "On criteria for assessing the financial condition of credit institutions." The assessment is largely based on the evaluation of the credit institution's own funds (capital) and liquidity. Based on the assessment results, credit institutions are classified as financially sound (Category I) or problematic (Category II). These categories are further subdivided into two groups. The classification of credit institutions is done on the basis of formalised criteria by specialised software. Territorial branches also use professional judgement for assessment purposes.

The introduction of an early warning system to detect problems in credit institutions is expected in 2005, after which the system will be implemented in supervisory practice.

INSPECTION OF CREDIT INSTITUTIONS

On-site inspections of credit institutions are carried out by the Bank of Russia as part of its banking regulation and supervision functions. The Bank of Russia cannot perform more than one inspection of a credit institution (its branch) focused on the same issues over the same accounting period, unless such an inspection is performed in connection with the reorganisation or liquidation of the credit institution or upon a motivated decision of the Board of Directors of the Bank of Russia. A repeat inspection upon the motivated decision of the Board of Directors is carried out with the participation of representatives of the Bank of Russia Headquarters.

The inspection cannot cover more than five calendar years of business of the credit institution (its branch) preceding the year of the inspection.

PRINCIPAL AIMS OF INSPECTIONS

The principal aim of an inspection of a credit institution is to assess the general situation in the credit institution or a certain line of its business, including:

– assessment of compliance with laws of the Russian Federation and Bank of Russia regulations;

- assessment of the reliability of the accounts (reports) of the credit institution;
- determination of the amounts of its risks, assets and liabilities;
- assessment of the quality of the assets of the credit institution, as well as the amount and adequacy of its own funds (capital);
- assessment of the risk management system and the internal control function of the credit institution;
- assessment of the financial condition and prospects of the credit institution; and
- identification of threats to the interests of the creditors and depositors of the credit institution.

MAIN TYPES OF INSPECTIONS:

Inspections of credit institutions (their branches) are of two types:

- *comprehensive* – covering all principal lines of business of the credit institution over a period of time, completed within 60 business days; or
- *targeted* (thematic) – covering specific lines of business or types of bank operations or other transactions carried out by the credit institution over a period of time, completed within 35 business days.

Depending on the number of territorial branches of the Bank of Russia responsible for the supervision of the structural units of the credit institution covered by the same inspection, all inspections are subdivided into:

- *regional* – inspections of structural units of a credit institution supervised by one and the same territorial branch of the Bank of Russia; or
- *inter-regional* – inspections of structural units of a credit institution supervised by several different territorial branches of the Bank of Russia.

Inspections of credit institutions (their branches) can also be:

- *scheduled* (regular) – such inspections are carried out under a Consolidated Annual Plan of comprehensive and targeted inspections of credit institutions compiled for the next calendar year, which can, however, be amended as required; or
- *unscheduled (ad hoc)* – carried out upon a decision of the Board of Directors of the Bank of Russia, the Chairman of the Bank of Russia (or acting Chairman) or the Banking Supervision Committee of the Bank of Russia,

or upon a decision of the management of the Bank of Russia following a proposal of a structural unit of the Bank of Russia, the head of a territorial branch of the Bank of Russia (in case of a regional inspection) or the General Inspector of an inter-regional inspectorate.

HOW CAN INSPECTORS MAKE THE INSPECTION RISK-ORIENTED?

In order to make supervision risk-oriented, special attention should be paid to risks of credit institutions and to the assessment of their risk management and internal control systems when determining the frequency of inspections and preparing them. The *frequency of inspections* in credit institutions is set by federal laws and Bank of Russia regulations (at least once a year) and is determined depending on the financial condition of the credit institution, its risk profile, the quality of its risk management and internal control systems, the reliability of its accounts (reports) and the results of previous inspections in the credit institution.

The risk management and internal control systems of the credit institution and its financial condition and prospects are assessed by exercising professional judgement. The professional judgement of the working group of inspectors is based on documents (information) received from the credit institution and calculations made by the head and/or members of the working group. It is also the basis for assessing the degree of reliability of the institution's accounts (reports). The professional judgements of the working group and the reasons behind them are specified in the inspection report and/or post-inspection letter.

HOW DOES AN ON-SITE SUPERVISOR PREPARE FOR AN INSPECTION?

An on-site inspection of a credit institution is prepared on the basis of the information available in the Bank of Russia. Preparation helps determine the scope of the inspection, the period to be inspected and the documents (information) required for the inspection. Prior to inspections, supervisors should evaluate the following:

– the financial condition of the credit institution;

– the credit institution's risk profile;

– the risk management and internal control systems of the credit institution;

– the reliability of financial reports submitted by the credit institution to the Bank of Russia;

– the correction of weaknesses and problems revealed during previous inspections of the credit institution; and

– compliance of the credit institution with the Federal Law "On anti-money laundering activities and combating the financing of terrorism."

PRECONDITIONS FOR INDEPENDENT AND SUCCESSFUL INSPECTIONS

Besides having the right to make professional judgements, members of the working group must not only be competent, but also independent. Therefore, the authorised representative of the Bank of Russia included in the working group must, before the inspection, provide the officer of the Bank of Russia who is to sign the inspection assignment with the following information about himself/herself (if applicable):

– whether or not he/she is a close relative (parent, spouse, brother, sister, child, or the brother, sister, parent or child of a spouse) of any of the shareholders (owners), members of the board of directors (or supervisory board), or the chief executive officer of the credit institution, etc., if the above persons can influence management decisions of the credit institution;

– whether or not he/she holds stocks (shares) in the supervised credit institution;

– whether or not he/she has placed his/her own funds with the supervised credit institution; and

– whether or not his/her close relatives have placed their own funds with the supervised credit institution or received funds or other property from the supervised credit institution.

The officer of the Bank of Russia who is to sign the inspection assignment reviews the information provided by the authorised representative of the Bank of Russia and decides on the expedience of the latter's participation in the working group.

POWERS OF THE INSPECTOR DURING AN ON-SITE INSPECTION

The authorised representatives (on-site supervisors) of the Bank of Russia are entitled to obtain and inspect financial statements and other documents of credit institutions (their branches), and make copies, if required, of the documents to include them in the inspection materials. Such documents include all the documentation (information) related to the activities of the supervised institution over the supervised period deemed necessary for the aims of the inspection, particularly:

– the authorisation and other documents relating to the authorisation of the credit institution and obtaining of its banking licence;

– internal documents of the credit institution;

– materials of the internal control and/or internal audit function(s) of the credit institution;

– analytical and synthetic accounting documents of the credit institution;

– accounting, statistical and financial reports of the credit institution; and

– other documents available in the credit institution pertaining to the inspection (at the discretion of the head of the working group).

The top manager and employees of the inspected credit institution must provide to the head of the working group and its members free access not only to documents (information) required for the inspection, but also to the bank's data storage and information systems in the read-only mode in order for them to be able to select any necessary information and make paper of electronic copies of any documents (information), including those stored in the bank's data storage and information systems.

INSPECTION RESULTS AND THEIR REFLECTION IN THE INSPECTION REPORT AND THE POST-INSPECTION LETTER

The results of the on-site supervisory inspection of the credit institution are reflected in the inspection report and the post-inspection letter. If the credit institution inspected has branches, a consolidated inspection report is compiled.

The inspection report consists of three parts: introduction, analysis and conclusions. The structure of the analytical part of the inspection report is determined by the business lines of the credit institution (its branch) inspected. This part of the inspection report contains information on the following:

– documents (information) provided/not provided by the credit institution during the inspection;

– reliability of accounts (reports) of the credit institution;

– weaknesses and problems in the activities of the credit institution not rectified by the date of their identification;

– rectification by the credit institution, after the inspection completion date, of the weaknesses and problems revealed during the inspection; and

– improper account-keeping (reporting) of the credit institution.

This part of the report should reflect the conclusions of the working group with regard to the results of the inspection and should also contain other supervisory information required to determine the level of risks, the amount of assets and liabilities of the credit institution, and the amount and adequacy of its own funds (capital). It should also include an assessment of the risk management and internal control systems of the credit institution, and its financial condition and prospects for the future.

If facts (events) and circumstances are revealed which require immediate legal or regulatory action in respect of the credit institution, an interim inspection report may be compiled before the completion of the inspection.

The officer who authorised the inspection can commission a partial inspection report addressing specific lines of business of the credit institution before the inspection is completed.

The inspection report is compiled and sent to the credit institution for information, with attachment of copies of documents of the credit institution confirming the improper account-keeping (reporting) of the credit institution, or the weaknesses and shortcomings of the business of the credit institution revealed during the inspection.

SUPERVISORY CORRECTIVE ACTIONS

The powers of the Bank of Russia as regards supervisory corrective actions against credit institutions are laid down in the Federal Law "On the Central Bank of the Russian Federation" (Articles 73 and 75), the Federal Law "On banks and banking" (Articles 19, 20 and 23.1), the Federal Law "On insolvency (bankruptcy) of credit institutions" (Articles 4, 7-17, 32, 33 and 35) and the regulations of the Bank of Russia implementing them, including Instruction No 59 of the Bank of Russia of 31 March 1997 "On corrective actions against credit institutions."

The following actions may be taken against credit institutions:

- preventive actions (letters, meetings, consultations);
- penalties;
- actions restricting the activities of the credit institution (limiting or prohibiting certain bank operations);
- replacement of managers of the credit institutions; and
- revocation of banking licences.

This list is much shorter than recommended by the Basel Committee on Banking Supervision. Out of the 16 supervisory corrective actions with which banking supervisors are to be empowered in accordance with the Supervisory Guidelines for Dealing with Weak Banks (Basel Committee on Banking Supervision, 2002), the Bank of Russia only uses 9 (slightly more than half) and all of them have a direct impact on the banks. Out of the five supervisory corrective actions recommended by the Basel Committee on Banking Supervision with an impact on managers and owners of banks, Russian law has granted none to the supervisor.

The lack of supervisory powers leads to a formal approach to corrective actions and also, in some cases, to unnecessary fault-finding.

Corrective actions against credit institutions may be taken by the Headquarters of the Bank of Russia and by the territorial branches of the Bank of Russia in accordance with the procedures stipulated by current federal law and Bank of Russia regulations. Decisions on the revocation of the banking licence of a credit institution and the introduction of a temporary administration in a credit institution are taken by the Banking Supervision Committee of the Bank of Russia.

The main purpose of corrective actions is to regulate the business of credit institutions in order to bring it into compliance with the norms and requirements set by the federal law and the Bank of Russia. Corrective actions are taken against the credit institution as a whole, considering all its weaknesses and violations. The choice of corrective actions should be guided by the efficiency of the solutions and should depend on the nature of the weaknesses, their causes, the overall financial condition of the credit institution and its role in the regional and federal banking markets. The supervisor should know exactly why, when and what corrective actions are to be used.

Unfortunately, not all of the above criteria for selecting corrective actions are applied by territorial branches of the Bank of Russia at all times. The actions are often untimely and inadequate. For instance, for a long time one of the actions most widely used by territorial branches of the Bank of Russia was penalties (presumably, a corrective action is taken, though in fact it is not too painful for the supervised bank).

The implementation of risk-oriented approaches to supervision implies professional judgements by supervisors regarding the quality of the assets of the supervised credit institutions, the amount of their liabilities and own funds (capital), and also the quality of corporate governance, including the quality of the banks' management and risk control systems and the transparency of their ownership structure. Although Article 75 of the Federal Law on the Central Bank of the Russian Federation stipulates that the Bank of Russia may take corrective actions under Article 74 of the said Law if the analysis of the business of credit institutions (banking groups) reveals any situations threatening the lawful interests of their depositors and creditors or the stability of the banking system of the Russian Federation, the Law does not explicitly recognise the right of the Bank of Russia to take supervisory corrective actions against credit institutions based directly on professional supervisory judgement. The efficiency of supervisory action is also reduced by restricting the scope of situations when supervisors have powers to dismiss executives and managers of credit institutions, to suspend all or some shareholders from taking part in the management of credit institutions, including the right to vote, etc., and to impose on credit institutions requirements concerning their corporate governance and risk management, including the composition of management reports.

8.5 FINANCIAL REHABILITATION OF CREDIT INSTITUTIONS

The Bank of Russia implements government policy in the fields of bankruptcy prevention and financial rehabilitation of credit institutions in accordance with the Federal Laws "On the Central Bank of the Russian Federation", "On banks and banking," and "On the insolvency (bankruptcy) of credit institutions," as well as the respective regulations of the Bank of Russia.

The insolvency (bankruptcy) of credit institutions is being prevented at three levels: the credit institution itself, the territorial branch of the Bank of Russia, and the Bank of Russia.

The practical objectives of the supervisory departments of the Bank of Russia in preventing insolvency (bankruptcy) of credit institutions are as follows:

- control of credit institutions' compliance with the Federal Law on the insolvency (bankruptcy) of credit institutions as regards bankruptcy prevention and financial rehabilitation;

- requesting in a timely manner that credit institutions take relevant action to prevent their insolvency (bankruptcy) and also bring their own funds (capital) into line with their authorised capital;

- expert assessment of measures aimed at financial rehabilitation (reorganisation) of credit institutions and control of the implementation of such measures; and

- control of the activities of temporary administrations of credit institutions as a means of preventing bankruptcy.

Actions aimed at preventing bankruptcy of credit institutions
If the circumstances of credit institutions fall under the Federal Law on the insolvency (bankruptcy) of credit institutions, the Bank of Russia is empowered to take the following actions to prevent their bankruptcy:

- financial rehabilitation of the credit institution;

- appointment of a temporary administration to manage the credit institution; and

- reorganisation of the credit institution.

If there are grounds to take action to prevent the bankruptcy of a credit institution, its founders (shareholders) must take appropriate and timely steps towards financial rehabilitation or reorganisation of the credit institution.

Credit institutions may take action to prevent bankruptcy either upon orders of the Bank of Russia or independently.

If the above grounds arise, the Bank of Russia is entitled to require that the credit institution:

– takes financial rehabilitation measures;

– brings its authorised capital into line with its own funds (capital);

– reorganises itself.

On receipt of the requirement from the Bank of Russia, the credit institution must decide on the necessary financial rehabilitation measures, i.e. develop and implement a financial rehabilitation action plan.

The procedures and time frame for submitting the credit institution's financial rehabilitation action plan, as well as the procedures and time frame for verifying its implementation, are laid down in Bank of Russia regulations.

If the credit institution's own funds (capital) at the end of the reporting month are less than its authorised capital according to its authorisation documents, the credit institution must take action to increase its own funds (capital) so that they equal the authorised capital or, if such an increase is impossible, to reduce its authorised capital to the level of its own funds (capital) and amend its authorisation documents accordingly, pursuant to regulations of the Bank of Russia.

The credit institution's failure to satisfy the requirements of the Bank of Russia is a ground for supervisory action by the Bank of Russia, as stipulated by federal law.

From the date when the grounds for supervisory action aimed at preventing bankruptcy arise until the date of the elimination of such grounds, the credit institution must notify the Bank of Russia of any general meetings of its founders (shareholders) and any meetings of its board of directors (supervisory board), to which the Bank of Russia can send observers; the institution must also inform the Bank of Russia of any connected-party transactions and major transactions it performs.

TEMPORARY ADMINISTRATION TO MANAGE A CREDIT INSTITUTION

One of the measures aimed at preventing bankruptcy is the appointment by the Bank of Russia of a special authority to manage a credit institution – the temporary administration.

The Federal Law on the insolvency (bankruptcy) of credit institutions contains an exhaustive list of grounds for the appointment of a temporary administration

to manage a credit institution. Under the current Law, the term of such an administration cannot exceed six months. If, by the date of expiration of the powers of the temporary administration, grounds still exist in the credit institution for its appointment, the temporary administration requests that the Bank of Russia revoke the credit institution's banking licence.

If a temporary administration is appointed, the powers of the executive bodies of the credit institution may be limited or suspended.

If the powers of the credit institution's executive bodies are limited, the temporary administration carries out an investigation to ascertain whether there are any grounds for the revocation of the banking licence under federal law, takes part in developing financial rehabilitation measures, and also controls the implementation of such measures and the disposal of the property of the credit institution.

If the powers of the credit institution's executive bodies are suspended, such powers are exercised by the temporary administration. It takes action to protect the property and documents of the bank, to identify the creditors of the credit institution and to establish the amounts of their pecuniary claims, and also to recover the debts owed to the credit institution. In this case, the executive bodies of the credit institution are not entitled, during the period of temporary administration, to take decisions on any issues referred to their competence by the federal law and the authorisation documents of the credit institution. Decisions of other management bodies of the credit institution become effective only upon approval of the temporary administration.

The temporary administration may request that the Bank of Russia impose a moratorium on the satisfaction of the claims of the credit institution's creditors.

The decision to terminate the temporary administration is taken by the Bank of Russia after the elimination of the grounds for its appointment, i.e. if the financial rehabilitation of the credit institution is successful or if the competent court of arbitration declares the institution bankrupt (leading to the commencement of bankruptcy proceedings and the appointment of a receiver/liquidator).

8.6 ANTI-MONEY LAUNDERING ACTIVITIES AND COMBATING THE FINANCING OF TERRORISM

The general globalisation trends, the rapid development of information and communication technologies and the intensification of cash flows inevitably make the banking system more vulnerable to attempts to use it for the legalisation of criminal incomes and the financing of terrorism. Funds of criminal origin entering the banking system pose a serious threat to its stability

by greatly increasing the probability of risks, above all legal, credit and operational risks, as well as reputational risk. The activities of credit institutions aimed at preventing and counteracting money laundering and combating the financing of terrorism (hereafter referred to as "AML/CFT") are today an important component of the risk management framework and a priority task for the Russian banking community. This trend has also redirected the priorities of banking supervision from formal, compliance-based supervision to risk-oriented supervision based on motivated professional judgement regarding the business of banks and aimed at assessing possible risks stemming from potential involvement of credit institutions or their customers in schemes connected with legalising criminal incomes or financing terrorism.

The legal framework for AML/CFT activities in the Russian Federation is stipulated by the Federal Law "On anti-money laundering activities and combating the financing of terrorism".

The principal efforts of credit institutions in the field of AML/CFT are connected with their functions outlined in the Federal Law: to identify operations subject to mandatory control (according to the criteria stipulated by the law) and doubtful operations (according to additional attributes), and to provide information on such operations directly to the competent authority (the Russian Federal Financial Monitoring Service, or *Rosfinmonitoring*) in accordance with the procedures stipulated by the Bank of Russia. The description of such efforts is contained in the Federal Law and includes:

– developing internal control procedures for AML/CFT and their implementation programmes;

– appointing special officers to ensure compliance with such procedures and implementation of such programmes; and

– implementing other internal institutional measures aimed at AML/CFT.

Recommendations on the development of AML/CFT internal control procedures in credit institutions have been prepared and approved by the Bank of Russia in accordance with the powers conferred upon it by the Federal Law on anti-money laundering activities and combating the financing of terrorism. They are based on the 40 Recommendations of the Financial Action Task Force on Money Laundering (FATF), the standards of the Basel Committee on Banking Supervision and the Global Anti-Money Laundering Guidelines for Private Banking (the Wolfsberg Principles), and also draw on the best practices of credit institutions in developed industrialised countries and of Russian banks in such activities. The recommendations contain a set of measures (programmes), which credit institutions should implement for AML/CFT purposes, including:

– "know your customer/beneficiary" procedures;

– procedures to identify in the customers' business operations funds and other property which are subject to mandatory control and other doubtful operations;

– rules for record-keeping and storage of information, and also training of credit institutions' employees in AML/CFT; and

– procedures for refusing to enter into bank account agreements and to carry out customers' instructions regarding operations, and also for suspending customers' operations in cases stipulated by the Federal Law on anti-money laundering activities and combating the financing of terrorism.

Credit institutions must develop their AML/CFT internal control rules on the basis of the recommendations of the Bank of Russia and determine the scope of their implementation depending on the nature of their own business and their customers' business (always ensuring compliance with the Federal Law on anti-money laundering activities and combating the financing of terrorism and Bank of Russia regulations).

Dedicated officers (AML/CFT officers) are responsible for ensuring compliance with the internal control rules and their implementation programmes. The AML/CFT officers must fulfil the qualification requirements of the Bank of Russia. The Bank of Russia also determines the qualification requirements that apply to the employees of the AML/CFT unit of the credit institution, if such a unit exists in the credit institution.

Taking into account the nature of their business, their customers' business, the risk of the customers being involved in legalisation of criminal incomes or financing of terrorism, credit institutions develop AML/CFT employee training and education programmes. The Bank of Russia has set the standards for AML/CFT education and training in credit institutions, regulating issues such as development and approval of AML/CFT training curricula by the credit institutions (including the organisation and methods of training and the testing of the credit institution's employees in AML/CFT); the drafting of the training programme (including AML/CFT training material, schedules and persons responsible for the training); and also the list of structural units of the credit institution whose employees must be trained in AML/CFT.

In order to ensure that credit institutions can supply the competent authority with the information stipulated by the Federal Law on anti-money laundering activities and combating the financing of terrorism, the Bank of Russia has provided for the use of the Bank of Russia's information/telecommunication networks for such purposes. The information is transmitted electronically with the use of state-of-the-art encoding technologies ensuring reliable protection of the information against unauthorised access. Furthermore, the use of standardised formats allows automated processing of the information at the competent authority.

In order to prevent the banking system from being used to finance terrorism, the Bank of Russia regularly provides credit institutions with lists of persons involved in extremist activities, which are compiled by the Federal Financial Monitoring Service.

CONTROL OF CREDIT INSTITUTIONS' COMPLIANCE WITH THE AML/CFT LAWS

Under the Federal Law on anti-money laundering activities and combating the financing of terrorism, the Bank of Russia, in its supervisory function, controls whether credit institutions comply with AML/CFT laws, striving to assess any possible risks of credit institutions or their customers being involved in operations connected with money laundering and the financing of terrorism in order to be able to take timely preventive supervisory action.

THE MAIN FORMS OF CONTROL ARE:

1. *Off-site (ongoing) supervision*, with an emphasis on proactive banking supervision based on the use of IT and analytical systems to monitor the current condition of credit institutions and their compliance with AML/CFT laws and regulations in order to identify any negative trends in credit institutions' AML/CFT activities as early as possible.

2. *On-site inspections* of credit institutions, based on off-site supervision data and the guidelines prepared and regularly updated by the Bank of Russia.

The supervisory activities in the field of AML/CFT are carried out by the Bank of Russia along the following main lines:

– inspecting the functions of internal control over the implementation of federal laws and Bank of Russia regulations on AML/CFT in credit institutions;

– controlling compliance of credit institutions' everyday business with these laws and regulations; and

– inspecting compliance of credit institutions' everyday business with their own internal control rules for AML/CFT and respective implementation programmes.

These activities are based on an integrated approach including:

– development and improvement of off-site and on-site supervisory methods for checking the credit institution's compliance with AML/CFT laws and regulations;

– preliminary processing and analysis of off-site supervision data, including statistical reports of the credit institution and available information about the credit institution and the operations of its customers, in order to determine priority areas for on-site inspections;

– on-site inspections of the credit institution and analysis of the weaknesses and faults revealed and their effect on the efficiency of the credit institution's efforts in AML/CFT; and

– overall assessment of the compliance of the credit institution's activities with federal laws and Bank of Russia regulations on AML/CFT.

Corrective actions against credit institutions that fail to comply with the federal laws and Bank of Russia regulations on AML/CFT
In case a credit institution violates the laws of the Russian Federation and regulations of the Bank of Russia on AML/CFT, and considering the totality of the violations revealed and the threat they pose to the interests of creditors (depositors), the Bank of Russia takes preventive action against the credit institution by notifying its management of the shortcomings in its activities and/or by taking corrective action such as:

– demanding the rectification of the violations revealed;

– limiting certain types of banking operations;

– prohibiting certain types of banking operations;

– imposing penalties.

A unique feature of the corrective action taken against credit institutions for non-compliance with the AML/CFT law is the right of the Bank of Russia to revoke the credit institution's banking licence in case of repeated violation, within one year, of the Federal Law on anti-money laundering activities and combating the financing of terrorism, provided it poses an actual threat to the interests of creditors and depositors.

8.7 MONITORING OF FINANCIAL STABILITY IN THE BANKING SECTOR

Under Russian law, the development and stability of the banking system are among the goals of the Bank of Russia. These goals cannot be fully attained without the analysis of the strengths and weaknesses of individual banks and of the banking sector as a whole and without assessing its vulnerability and taking timely action to prevent it. Therefore, financial stability monitoring has always been a priority for the Bank of Russia.

The Bank of Russia assesses on a regular basis the financial stability of the banking sector and informs all the parties concerned of its findings. For three years already, the Bank of Russia has prepared and published the "Report on the Development of the Banking Sector and Banking Supervision"[30]. This report

30 The reports are available in Russian under: http://www.cbr.ru/analytics/bank_system/.

is designed to inform the public about the banking system, the risks connected with the banking business, the changes in the macro-prudential indicators of the banking sector, and the sector's systemic stability and prospects. It contains comprehensive information on the situation in the banking regulation and supervision system, and the current priorities in banking supervision. The Bank of Russia is continuously improving this publication, expanding the scope and range of the analytical tools used, and bringing it closer to the best international practices in financial stability reporting.

The Bank of Russia is developing *financial stability monitoring at the meso (peer groups) and macro levels*. In micro-prudential analysis, it intends to improve its guidelines for the analysis of credit institutions' financial standing and the *Bank Financial Soundness Indicators* software developed in 2000, to include specific areas such as the analysis of banks with branches (including an analysis of branch bank reporting) and the analysis of consolidated statements to ensure the early identification of higher risks in the operations of banking/consolidated groups, with the results of this latter analysis being included in the assessment of the financial stability of the member credit institutions of such groups.

The Bank of Russia has established a *system for the analysis of consolidated indicators of credit institutions' business and development of banking services by region*. The Bank of Russia assumes that regular analysis of credit institutions' business and development of banking services in a region will help to reveal current trends in the banking sphere. Since the analysis results are available at the Corporate Portal (Intranet) of the Bank of Russia, territorial branches can compare the results across the regions. This analysis thus serves as a tool for evaluating the stability of the banking system.

A significant impetus in the development of macro-prudential analysis tools was given by the IMF- and the World Bank-sponsored Financial Sector Assessment Program (FSAP) for Russia in 2002-03. The Program led to a comprehensive analysis and evaluation of the condition of the Russian banking sector (also by means of stress testing), including such aspects as the concentration of risks of credit institutions, the capitalisation of the banking sector and quality of bank capital, transparency of credit institutions' business, competition in the banking sector and household deposit insurance. The Bank of Russia continues to conduct regular *stress testing* exercises, improving the methodology developed jointly in consultations with the IMF and World Bank experts during work on the FSAP.

Regular stress testing is currently performed not only by the Bank of Russia, but also by a number of credit institutions. In early 2005, the Bank of Russia studied the practice of stress testing by Russian credit institutions. The results of the survey demonstrate considerable progress as regards the use of stress testing methods by credit institutions: currently about 80% of the credit institutions surveyed use stress testing, compared with just 30% two years ago.

The Bank of Russia has prepared Guidelines on stress testing for credit institutions[31]. The very fact that credit institutions use stress testing methods can be considered as an indicator of the maturity and sophistication of credit institutions' risk management systems. According to both domestic and foreign experience, the most efficient way of identifying risks, including systemic risks, is through the analysis by credit institutions of their asset portfolio, as they have full and reliable information.

As a means of developing macro-prudential monitoring and enhancing transparency of the activities of credit institutions and the whole of the banking sector, the Bank of Russia has, for a number of years, included in its analytical publication called the "Russian Federation Banking Sector Review" a monthly collection of *macro-prudential indicators* reflecting key parameters of the Russian banking sector.

A very important role in the assessment of the Russian banking sector, particularly in the light of cooperation with international financial institutions, is played by the calculation and analysis of *financial soundness indicators* (FSIs) developed by the IMF. The Bank of Russia takes an active part in the Coordinated Compilation Exercise (CCE), which is a stage of the IMF working program aimed at enhancing macro-prudential analysis of financial systems. The aims of the CCE are: the improvement of countries' ability to determine financial soundness indicators representative of their financial systems; the development of methods to ensure international compatibility of FSIs; the coordination of efforts of the national authorities in implementing FSI calculations; and the publication of FSIs to enhance the transparency of countries' financial sectors.

Another tool to efficiently identify adverse trends in the banking sector and take action to prevent them is *financial stability monitoring*. The banking sector monitoring system being developed by the Bank of Russia is largely based on the financial soundness indicators and the IMF Financial Soundness Indicators Compilation Guide. Nevertheless, since FSIs only represent one of the inputs required for macro-prudential analysis, they have been supplemented by indicators describing the broader economic and financial situation, such as asset prices, loan growth, GDP growth and its individual components, inflation, indicators of the external economic situation, etc.

8.8 ESTABLISHMENT OF THE DEPOSIT INSURANCE SCHEME

On 23 December 2003, the Federal Law No 177-FZ "On the insurance of household deposits in banks of the Russian Federation" (hereafter referred to as the "Deposit Insurance Law") was adopted, establishing the legal, financial and institutional framework of a mandatory insurance system for household

31 The Guidelines are available at: http://www.cbr.ru/analytics/bank_system/print.asp?file=stress.htm

deposits in the Russian Federation's banks. The Deposit Insurance Law is aimed at protecting the rights and lawful interests of persons with deposits in the banks of the Russian Federation.

The deposit insurance scheme is mandatory for all banks possessing a licence from the Bank of Russia to take household deposits and open and keep personal bank accounts. Article 43 of the Deposit Insurance Law stipulates the procedures for participating in the deposit insurance scheme applicable to banks having such a licence from the Bank of Russia as at the date of entry into force of the Law. Such banks can be registered by the State Deposit Insurance Agency as members of the deposit insurance scheme upon notification that the Bank of Russia is satisfied that the bank complies with the deposit insurance scheme participation requirements. The rules and procedures for granting of such permission by the Bank of Russia are stipulated in Regulation No 248-P of the Bank of Russia of 16 January 2004.

The banks which, as at the date of entry into force of the Law, were not licensed to take personal deposits or open and keep personal bank accounts can obtain such permission from the Bank of Russia in accordance with the procedures stipulated by Chapter 14 of Instruction No 109-I of the Bank of Russia of 14 January 2004 on the procedure of the Bank of Russia concerning the authorisation of credit institutions and the issuing of banking licences, provided that they comply with the insurance scheme participation requirements. Article 27 of the Deposit Insurance Law requires that the Bank of Russia should, when issuing such a licence to a bank, notify the State Deposit Insurance Agency of it not later than the business day following the day of issue.

Under Article 44 of the Deposit Insurance Law, the banks participating in the deposit insurance scheme must comply with the participation requirements at all times.

The participants in the deposit insurance scheme are individual depositors, banks included in the Bank Register, the State Deposit Insurance Agency and the Bank of Russia. The duties of banks participating in the deposit insurance scheme are laid down in Article 6 of the Deposit Insurance Law.

This Law lays down the procedures and conditions for depositors to claim compensation in the event of a loss resulting from a bank failure (including how to determine whether a loss has occurred and the amount of compensation payable). It also provides for the deposit insurance scheme's financial stability and for the control over the functioning of the scheme.

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ANNEX 1

EXERCISE ON THE ASSESSMENT OF A HYPOTHETICAL BANK'S PERFORMANCE

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INTRODUCTION

The following pages provide you with the figures contained in the basic financial reports of a hypothetical bank, describing its financial position over a three-year period. This hypothetical bank does not of course exist; the whole exercise has purely been constructed for the benefit of the readers of this book. The exercise has been designed to describe the main possible directions that a bank's performance can take. The figures and the structure of the basic financial reports have been simplified to allow you to calculate key financial ratios that will help you interpret the bank's financial health. The financial statements and the underlying assumptions are designed to show a particular development in the financial situation and may vary from the reality in any country. In the balance sheet and profit and loss account, all numbers are in thousands, and all foreign currency positions are shown with their value measured in domestic currency. Many of the ratios referred to can be found in this book or in the IMF Compilation Guide on Financial Soundness Indicators.

YOUR TASK

Based on the available financial statements, you should analyse the bank's financial performance and stability. Form your opinion on the basis of the basic ratios that are suggested in the exercise, showing the significant changes in the bank's results. When you calculate the proposed ratios, try to determine the main reasons behind possible changes. You should also assess the measures and adjustments that could lead to an improvement in these ratios. Use the tables provided with particular pre-calculated examples. You should complete all empty fields in the tables and summarise your findings. Simply follow the description of the ratios and fill in the missing figures.

1. *Profitability exercise:* Analyse the profitability of the hypothetical bank, and assess what it means for the bank's overall condition and for its future.
2. *Capital adequacy exercise:* Determine if the bank complies with the minimum capital adequacy ratio of 8 percent. Provide an explanation for any change in the capital adequacy ratio and assess what implications such changes may have on the overall condition of the bank.
3. *Asset quality exercise:* Analyse the bank's level of growth and the quality of its loan portfolio.
4. *Foreign exchange risk exercise:* (i) Determine the net currency position by simply deducting total foreign currency liabilities from total foreign currency assets. (ii) Determine if the bank complies with the prudential limits applicable to foreign exchange open positions by calculating the net position compared with the capital base and the overall open position. (iii) Analyse the consequences of adverse exchange rate movements.
5. *Formulate a supervisory action plan.* For example, whether there should be (a) an on-sight inspection, and if so, when? (b) Based on your off-sight analysis of the balance sheet and profit and loss account, explain which areas you would recommend the on-sight inspector(s) to focus on (e.g. the loan portfolio)?
6. *What is your opinion of the quality of on-site and off-site supervision in the case of this hypothetical bank?* Are there any measures that you would recommend the supervisory authority to take to improve the quality of supervision?

Balance sheet

Assets	2000 dom	2000 fc	2000 total
Cash	5,127	673	5,800
Central bank	20,404		20,404
Treasury bills and other eligible bills	8,617		8,617
Loans and advances to credit institutions/1	14,578	3,576	18,154
Loans and advances to non-financial enterprises and households/2	282,356	21,299	303,655
Securities/3	15,713	3,530	19,243
Intangible and tangible assets/4	5,030		5,030
Other assets/5	12,670	774	13,444
Total assets			**394,347**

Liabilities	2000 dom	2000 fc	2000 total
Central bank	4,281		4,281
Amounts owed to credit institutions/6	32,602	11,064	43,666
Amounts owed to non-financial enterprises and households/7	289,355	13,063	302,418
Other liabilities/8	12,617	744	13,361
Subordinated liabilities	0		0
Total liabilities			363,726
Shareholders' equity			
Paid-in capital	16,500		
Reserves	13,800		
Revaluation reserves	0		
Unallocated profits	321		
Total shareholders' equity	30,621		30,621
Total liabilities and shareholders' equity			**394,347**

Off-balance sheet	2000		
Commitments	16,415		16,415
Contingent liabilities:			
– Guarantees	13,472		13,472
– Documentary credits	7,500		7,500

Notes: dom = domestic currency, fc = foreign currency

2001			2002		
dom	fc	total	dom	fc	total
3,510	482	3,992	2,458	241	2,699
12,175		12,175	12,558		12,558
4,463		4,463	1,579		1,579
16,560	3,373	19,933	12,819	2,110	14,929
313,527	33,270	346,797	431,217	45,201	476,418
16,405	3,929	20,334	14,550	4,350	18,900
5,165		5,165	5,450		5,450
21,771	1,456	23,227	43,301	2,821	46,122
		436,086			**578,655**

2001			2002		
dom	fc	total	dom	fc	total
17,672		17,672	68,272		68,272
50,095	10,968	61,063	90,922	10,949	101,871
301,197	14,860	316,057	354,987	14,503	369,490
8,585	558	9,143	6,267	325	6,592
0		0	500		500
		403,935			546,725
16,500			16,500		
14,580			14,580		
255			600		
816			250		
32,151		32,151	31,930		31,930
		436,086			**578,655**

2001			2002		
25,674		25,674	42,500		42,500
20,736		20,736	25,600		25,600
9,700		9,700	11,300		11,300

Balance sheet – Notes

Note 1 Loans and advances to credit institutions	2000		
	dom	fc	total
Loans and advances to credit institutions	**14,578**	**3,576**	**18,154**
Current account	1,324	2,894	
Loans	13,254	682	

Note 2 Loans and advances to non-financial enterprises and households	2000		
	dom	fc	total
Loans and advances to non-financial enterprises and households	**282,356**	**21,299**	**303,655**
Short-term loans	140,078	8,544	
Long-term loans	34,316	8,618	
Mortgages	103,953	3,969	
Non-performing loans	8,430	517	
Loan provisions	-4,421	-349	

Note 3 Securities	2000		
	dom	fc	total
Securities	**15,713**	**3,530**	**19,243**
Corporate bonds	12,196	374	
Shares	3,517	3,156	

Note 4 Intangible and tangible assets	2000		
	dom	fc	total
Tangible assets	**5,030**		**5,030**
Buildings	2,600		
Furniture, fixtures and equipment	2,750		
Depreciation	-320		

Note 5 Other assets	2000		
	dom	fc	total
Other assets	**12,670**	**774**	**13,444**
Accrued income	2,810	328	
Accounts receivable	9,860	446	

Note 6 Amounts owed to credit institutions	2000		
	dom	fc	total
Amounts owed to credit institutions	**32,602**	**11,064**	**43,666**
Current account	25,568	9,315	
Loans	7,034	1,749	

Note 7 Amounts owed to non-financial enterprises and households	2000		
	dom	fc	total
Amounts owed to non-financial enterprises and households	**289,355**	**13,063**	**302,418**
Sight deposits			
Term deposits			

Note 8 Other liabilities	2000		
	dom	fc	total
Other liabilities	**12,617**	**744**	**13,361**
Accrued expenses	1,326	98	
Accounts payable	11,291	646	

2001			2002		
dom	fc	total	dom	fc	total
16,560	**3,373**	**19,933**	**12,819**	**2,110**	**14,929**
856	2,778		600	1,694	
15,704	595		12,219	416	

2001			2002		
dom	fc	total	dom	fc	total
313,527	**33,270**	**346,797**	**431,217**	**45,201**	**476,418**
132,559	12,934		151,806	15,993	
34,429	3,147		50,961	5,322	
134,813	16,503		163,782	22,668	
16,899	724		73,168	1,568	
-5,173	-38		-8,500	-350	

2001			2002		
dom	fc	total	dom	fc	total
16,405	**3,929**	**20,334**	**14,550**	**4,350**	**18,900**
12,127	387		10,200	1,200	
4,278	3,542		4,350	3,150	

2001			2002		
dom	fc	total	dom	fc	total
5,165		**5,165**	**5,450**		**5,450**
2,805			3,570		
2,750			2,750		
-390			-870		

2001			2002		
dom	fc	total	dom	fc	total
21,771	**1,456**	**23,227**	**43,301**	**2,821**	**46,122**
5,174	624		9,876	1,197	
16,597	832		33,425	1,624	

2001			2002		
dom	fc	total	dom	fc	total
50,095	**10,968**	**61,063**	**90,922**	**10,949**	**101,871**
23,961	9,282		35,072	9,274	
26,134	1,686		55,850	1,675	

2001			2002		
dom	fc	total	dom	fc	total
301,197	**14,860**	**316,057**	**354,987**	**14,503**	**369,490**
				10,478	
				4,025	

2001			2002		
dom	fc	total	dom	fc	total
8,585	**558**	**9,143**	**6,267**	**325**	**6,592**
902	83		645	47	
7,683	475		5,622	278	

Profit and loss account		
Operating income	**2001**	**2002**
Loans and advances to credit institutions	1,052	902
Loans and advances to non-financial enterprises and households	29,523	32,934
Interest income	**30,575**	**33,836**
Deposits by credit institutions	4,400	10,036
Deposits and borrowings from non-financial enterprises and households	10,823	12,697
Interest expenses	**15,223**	**22,733**
Net interest income	**15,352**	**11,103**
Net commission income	-	-
Net result from financial operations	-	-
Other operating income	1,502	1,291
Total operating income	**16,854**	**12,394**
Operating expenses		
Administrative expenses		
– Staff costs	6,241	8,290
– Other administrative expenses	2,075	2,398
Depreciation, amortisation and write-down of tangible and intangible fixed assets	200	480
Other operating expenses	180	248
Total operating expenses	**8,696**	**11,416**
Profit before loan loss provisions	**8,158**	**978**
Loan loss provisions	441	2,079
Operating profit	**7,717**	**-1,101**
Extraordinary profit	255	1,300
Extraordinary loss	-25	-8
Operating profit before tax	**7,947**	**191**
Tax on the profit for the year	2,649	64
Profit for the financial year	**5,298**	**127**
Distribution of profit for the financial year		
Dividends paid to shareholders	3,580	849
Reserves	1,000	0
Retained earnings	718	-722

PROFITABILITY EXERCISE

Interest margin to operating income

This financial soundness indicator is a measure of the relative share of net interest earnings within gross income. (Net interest income/operating income.)

Year	2001	2002
Net interest income	15,352	
Operating income	16,854	
Net interest income to operating income (%)	**91.1**	

ROA – Return on assets

ROA is a key ratio of profitability, indicating how efficiently a financial institution's assets are employed. (Profit for the financial year after tax/average total assets)

Year	2001	2002
Profit for the financial year	5,298	
Total assets at the beginning of the year	394,347	
Total assets at the end of the year	436,086	
ROA (%)	**1.28**	

Note: The average of total assets should be calculated using the amounts at the beginning and at the end of the year.

ROE – Return on equity

ROE is another key profitability ratio measuring how well shareholders' equity is being used. (Profit for the financial year after tax/average total shareholders' equity)

Year	2001	2002
Profit for the financial year	5,298	
Total shareholders' equity at the beginning of the year	30,621	
Total shareholders' equity at the end of the year	32,151	
ROE (%)	**16.9**	

Note: The average of shareholders' equity should be calculated using the amounts at the beginning and at the end of the year.

Cost/income ratio

The cost/income ratio measures a bank's efficiency. (Total operating expenses/total operating income)

Year	2001	2002
Total operating expenses	8,696	
Total operating income	16,854	
Cost/income ratio (%)	**51.6**	

Share of extraordinary profit

This ratio shows how important extraordinary items are for the bank in the reporting year, bearing in mind that such items are non-recurring (extraordinary), and may therefore potentially have a material effect on net income in a reporting period. (Extraordinary profits/operating profit after extraordinary items but before tax)

Year	2001	2002
Extraordinary profit	255	
Operating profit before tax	7,947	
Share of extraordinary profit (%)	**3.2**	

Dividends paid to shareholders in percent of net profit

The ratio highlights whether shareholders are being paid at the expense of the bank's financial consolidation. This occurs when the ratio is above 100%. (Dividends paid to shareholders/net profit for the financial year after tax)

Year	2001	2002
Dividends paid to shareholders	3,580	
Net profit for the financial year	5,298	
Dividends paid to shareholders in percent of net profit	**67.6**	

CAPITAL ADEQUACY EXERCISE

Capital adequacy ratios		
Item		**2000**
TIER 1		
Capital		16,500
Reserves		13,800
Unallocated profits		321
TIER 2		
Subordinated debt	max 50% Tier1	0
Revaluation reserves		0
CAPITAL BASE		**30,621**
	Risk Weight	**2000**
Loans and advances to credit institutions:		
– current account	20	4,218
– loans	100	13,936
Loans and advances to non-financial enterprises and households:		
– short and long-term loans	100	191,556
– mortgage loans	50	107,922
– non-performing loans	100	4,177
Securities	100	19,243
Intangible, tangible and other assets	100	18,474
Off-balance sheet items:		
– commitments	100	16,415
– guarantees	50	13,472
– documentary credits	20	7,500
Risk Weighted Assets (RWA)		
Capital requirement for banking portfolio	8% of RWA	
Capital adequacy		

		2001		2002	
	Weighted	2001	Weighted	2002	Weighted
	844				
	13,936				
	191,556				
	53,961				
	4,177				
	19,243				
	18,474				
	16,415				
	6,736				
	1,500				
	326,842	sum (d18:d29)			
	26,147	d31*0,08			
	9.37	c15/(d32/8)			

ASSET QUALITY EXERCISE

Non-performing loans/Total loans

The ratio identifies any problems with asset quality in the loan portfolio.

Year	2000	2001	2002
Non-performing loans	8,947		
Total loans	303,655		
Non-performing loans/Total loans (%)	**2.95**		

Loan provisions/Non-performing loans

Provisions against losses on loans for this ratio are defined as specific provisions, which are the stock of provisions/reserves held by the bank against losses on individual loans (including a collectively assessed group of loans). The ratio of such provisions to non-performing loans indicates how well covered the bank is against losses on non-performing loans as well as the adequacy of the provisioning policy.

Year	2000	2001	2002
Loan provisions	4,770		
Non-performing loans	8,947		
Ratio of loan provisions	**53.31**		

Non-performing loans net of provisions in relation to net interest income, reserves and shareholders' equity

This ratio compares non-performing loans net of provisions to net interest income, reserves and to total shareholders' equity. The ratio identifies how well the bank is able to cover losses through income, reserves or total shareholders' equity, taking as a starting point the fact that the bank would lose 100% on non-performing loans. In this context, the ratio is calculated by first deducting specific provisions from non-performing loans.

Year	2000	2001	2002
Non-performing loans net of provisions	4,177		
Net interest income	xxx		
Comparison 1 (%)			
Reserves	13,800		
Comparison 2 (%)	**30.27**		
Total shareholders' equity	30,621		
Comparison 3 (%)	**13.64**		

Change in the non-performing loan portfolio

This ratio compares the current non-performing loan portfolio with the non-performing loan portfolio in the previous year, and thereby describes any change in the quality of the loan portfolio.

Year	2000	2001	2002
Non-performing loans in previous year	xxx		
Non-performing loans in current year	8,947		
Change in non-performing loan portfolio			

Change in Loan Portfolio Index			
This ratio compares the loan portfolio in the current year with the loan portfolio in the previous year and describes the tendency in the portfolio's development.			
Year	**2000**	**2001**	**2002**
Loans and advances in previous year	xxx		
Loans and advances in current year	303,655		
Change in Loan Portfolio Index			

FOREIGN EXCHANGE RISK EXERCISE 1

Foreign currency-denominated assets to total assets			
Measures the relative size of foreign currency assets within total assets.			
Year	**2000**	**2001**	**2002**
Total foreign currency assets	29,852		
Total assets	394,347		
Foreign currency-denominated assets to total assets	**7.57**		

Foreign currency-denominated liabilities to total liabilities			
Measures the relative importance of foreign currency funding within total liabilities.			
Year	**2000**	**2001**	**2002**
Foreign currency funding/liabilities	24,871		
Total liabilities (excluding shareholders' equity)	363,726		
Foreign currency-denominated liabilities to total liabilities	**6.84**		

FOREIGN EXCHANGE RISK EXERCISE 2

Assessments as at 31 December 2002	
Item/Currency	
Cash	
Loans and advances to credit institutions: current accounts	
Loans and advances to credit institutions: loans	
Loans and advances to non-financial enterprises and households: short-term loans	
Loans and advances to non-financial enterprises and households: long-term loans	
Loans and advances to non-financial enterprises and households: mortgage loans	
Net non-performing loans	
Securities: corporate bonds	
Securities: shares	
Other assets: accrued income	
Other assets: accounts receivable	
Total foreign currency assets	
Amounts owed to credit institutions: current accounts	
Amounts owed to credit institutions: loans	
Amounts owed to non-financial enterprises and households: sight deposits	
Amounts owed to non-financial enterprises and households: term deposits	
Other liabilities: accrued expenses	
Other liabilities: accounts receivable	
Total foreign currency liabilities	
Exchange rate (per 1 unit of foreign currency)	
Exercise A	
Net currency position	long-short
Exercise B	
Capital base	
0	Tier1+Tier2
Net position compared with the capital base (%)	limit 15%
Overall open position (abbreviated method) max ((suma (all net long); suma (all net short))	
Exercise C	
Change in exchange rate (per 1 unit of foreign currency)	
Impact of exchange rate change on bank's income	Value of assets
	Value of liabilities
	New net position
	Profit
	Total impact on profit

All FX Currency	USD	GBP	EUR	JPY	CHF
241	144	0	81	16	0
1,694	1,016	84	169	101	324
416	0	0	0	416	0
15,993	11,994	2,558	879	0	562
5,322	2,128	638	1,703	0	853
22,668	4,760	14,054	453	680	2,721
1,218	584	243	73	36	282
1,200	900	300	0	0	0
3,150	1,008	913	630	315	284
1,197	598	359	119	35	86
1,624	730	535	97	24	238
54,723	**23,862**	**19,684**	**4,204**	**1,623**	**5,350**
9,274	2,782	3,709	1,391	463	929
1,675	0	0	0	1,675	0
10,478	1,571	6,286	2,095	209	317
4,025	2,535	442	483	161	404
47	6	13	13	4	11
278	66	75	55	44	38
25,777	**6,960**	**10,525**	**4,037**	**2,556**	**1,699**
x	**30**	**50**	**32**	**0,3**	**20**
28,946	**16,902**				
	limit 40% of capital base				
	27	51	33	0,29	21
	21,476				
	6,264				
	15,212				
	-1,690				

ANNEX 2

QUESTIONS FOR CHAPTERS 1 TO 7

Please note that there may be more than one correct answer to some of the following questions.

CHAPTER 1 – BANKING RISK

QUESTION 1.1: WHICH OF THE FOLLOWING ASSETS CARRIES CREDIT RISK?

(a) A loan.

(b) A guarantee.

(c) A government bond.

(d) A share.

(e) An option.

(f) The head office building owned by the bank.

QUESTION 1.2: WHICH OF THE FOLLOWING STATEMENTS REGARDING CREDIT RISK IS CORRECT?

(a) When assessing a borrower's creditworthiness, the bank should consider both the ability and the willingness of the borrower to honour future obligations.

(b) When a credit is collateralised, the bank does not need to assess the creditworthiness of the borrower.

(c) Banks in G-10 countries pay sufficient attention to the identification, measurement, management and control of credit risk, which is no longer a major cause of bank failures in those countries.

(d) The major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties. This experience is common in both G-10 and non-G-10 countries.

(e) Credit risk is one of several banking risks, none of which can be said to have been the major cause of bank failures in the past.

(f) Banking supervisors around the world no longer need to pay particular attention to credit risk because banks have well-developed systems for credit risk management and rarely experience problems in connection with credit risk.

(g) Banking supervisors are not responsible for banks' identification, measurement, management and control of credit risk. The responsibility rests with the bank's management.

QUESTION 1.3: WHICH OF THE FOLLOWING INSTRUMENTS CARRIES MARKET RISK?

(a) A loan

(b) A share

(c) A government bond

(d) A future

(e) The head office building owned by the bank.

QUESTION 1.4: WHICH OF THE FOLLOWING STATEMENTS REGARDING MARKET RISK IS CORRECT?

(a) Markets are fundamentally stable and banks do not need to have timely information in order to manage market risks. Information about the purchase price of a given asset is sufficient.

(b) A bank must monitor the development of the market price on a government bond although there is no risk that the government will default on the payment obligation.

(c) Banks should not enter into transactions carrying market risks without understanding the risk involved in a specific instrument.

(d) The major cause of serious banking problems in G-10 countries is directly related to a lack of identification, measurement, management and control of market risks. Market risks are not important in non-G-10 countries.

(e) Banking supervisors are not responsible for banks' identification, measurement, management and control of market risk. The responsibility rests with the bank's management.

QUESTION 1.5: WHICH OF THE FOLLOWING INSTRUMENTS CARRIES LIQUIDITY RISK?

(a) A loan

(b) A share

(c) A government bond

(d) Time deposits

(e) Subordinated debt

(f) Equity reserves.

QUESTION 1.6: WHICH OF THE FOLLOWING STATEMENTS REGARDING LIQUIDITY RISK IS CORRECT?

(a) Liquidity risk can lead to bank failures when customers withdraw funds more quickly than the bank can accommodate. Hence, liquidity risk is subject to a specific capital charge.

(b) Banking supervisors in the European Union have a common framework for the identification, measurement, management and control of liquidity risk.

(c) The process whereby banks map their liquidity positions to different maturity bands in order to identify maturity mismatches in asset and liabilities is often referred to as a maturity ladder.

(d) Supervisors in general expect banks to assess and estimate the quality of liquid assets, including a possible discount (e.g. haircut) to be expected in distressed sales.

(e) Banking supervisors are not responsible for banks' identification, measurement, management and control of liquidity risk. The responsibility rests with the bank's management.

QUESTION 1.7: WHICH OF THE FOLLOWING WOULD YOU ASSESS AS EVENTS ATYPICAL OF OPERATIONAL RISK EVENTS?

(a) The collapse of the bank's computer network.

(b) Losing a bill of exchange issued by a client.

(c) Strong outflow of deposits due to an article in a newspaper describing serious problems in the bank.

(d) A deficit arising at a cash counter.

(e) The damage of a customer's collateral.

(f) ATM theft.

QUESTION 1.8: WHICH OF THE BASEL II OPERATIONAL RISK APPROACHES SETS THE BETA FACTOR IN THE RANGE OF 12-18% FOR EACH PARTICULAR BUSINESS ACTIVITY WITHIN A BANK?

(a) The basic indicator approach.

(b) The standardised approach.

(c) The advanced measurement approach.

QUESTION 1.9: WHICH OF THE FOLLOWING BUSINESS LINES DOES NOT BELONG TO THE EIGHT BANKING ACTIVITIES DEFINED FOR THE STANDARDISED APPROACH FOR CALCULATION OF OPERATIONAL RISK CAPITAL CHARGE CALCULATION?

(a) Commercial banking.

(b) Payment and settlement.

(c) Retail brokerage.

(d) Legal services.

CHAPTER 2 – REGULATING AND SUPERVISING BANKS

QUESTION 2.1: WHICH OF THE FOLLOWING COMBINATIONS CORRECTLY REPRESENTS THE GOALS OF BANKING SUPERVISION?

(a) Maintaining confidence in the banking sector, protecting both depositors and banks and avoiding systemic risk.

(b) Maintaining confidence in the banking sector, protecting both depositors and creditors and avoiding systemic risk.

(c) Protecting of depositors and financial institutions, promoting sound practices for banking operations and avoiding systemic risks.

(d) Regulating banks, controlling banks' activities, protecting depositors and supporting banks financially as the lender of the last resort.

QUESTION 2.2: WHICH MODEL FOR SUPERVISION EXISTS IN THE EUROPEAN UNION?

(a) Banking supervision is a national responsibility in the European Union. All countries have financial supervisory authorities outside their central banks. These authorities are responsible for banking supervision.

(b) Banking supervision is a national responsibility in the European Union. Different supervisory models coexist: in some countries the central bank is responsible for banking supervision, in other countries the responsibility rests with a supervisory authority.

(c) Banking supervision is a European responsibility, which has been allocated to the European Institution for Banking Supervision.

QUESTION 2.3: WHAT IS THE ROLE OF A BANKING REGULATOR AND SUPERVISOR?

(a) The banking regulator issues the rules and provisions that banks have to comply with, thereby implementing banking law. The banking supervisor monitors whether banks adhere to the rules and provisions issued by the regulator.

(b) The banking regulator issues the national banking law. The banking supervisor sets the rules and provisions and monitors whether banks adhere to them.

(c) The banking regulator issues the rules and provisions that banks must comply with, thereby implementing banking law. The banking supervisor monitors the activities of the banking regulator.

QUESTION 2.4: WHO ISSUED THE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION?

(a) The International Organisation of Banking Supervisors.

(b) The Financial Action Task Force.

(c) The Financial Stability Forum.

(d) The Basel Committee on Banking Supervision.

(e) The Bank for International Settlements Regulatory Committee.

QUESTION 2.5: WHICH OF THE FOLLOWING PRINCIPLES IS NOT PART OF THE CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION?

(a) Principles for licensing and structure.

(b) Principles for information requirements.

(c) Principles for prudential regulations.

(d) Principles for capital adequacy.

QUESTION 2.6: WHICH PRINCIPLES ADDRESS THE SETTING UP OF ON-SITE AND OFF-SITE SUPERVISORY FUNCTIONS?

(a) Principles for formal powers of supervision

(b) Principles for methods of ongoing supervision

(c) Principles for prudential regulation and requirements

(d) Principles for information requirements.

QUESTION 2.7: WHICH PROCESSES IN BANKS ARE IMPORTANT FOR THE SUPERVISOR UNDER THE RISK BASED SUPERVISION APPROACH?

(a) Identification and measurement of risks.

(b) Management and control of risks.

(c) Quality of risk managers and reporting of risks.

CHAPTER 3 – LICENSING OF BANKS

QUESTION 3.1: WHAT IS THE SUPERVISOR CHECKING FOR IN THE LICENSING PROCESS WITH REGARD TO MANAGEMENT AND SHAREHOLDERS?

(a) That the board and senior management meet the "fit and proper test", which focuses on the competence, integrity and qualifications of the individuals proposed for such positions.

(b) That the shareholders are able to provide the initial capital of the bank and are committed to supporting the bank in the first year of operation.

(c) That the shareholder structure is comparable in complexity to the sophistication of the bank's operations and that the number of shareholders corresponds to the number of business lines that the bank establishes.

(d) The relationship between shareholders and managers and the distribution of roles between the two groups, to ensure that checks and balances are observed.

QUESTION 3.2: WHAT IS THE SUPERVISOR CHECKING IN THE LICENSING PROCESS WITH REGARD TO THE PROPOSED BUSINESS PLAN?

(a) Thorough assessment that there is a real need in the market for services that the bank intends to offer.

(b) A clearly stated vision and mission for the bank, identifying the specific market, product and services that the bank intends to offer.

(c) A proposal for the bank's internal organisation, which should be consistent with the proposed strategy.

QUESTION 3.3: WHICH OF THE FOLLOWING STATEMENTS IS CORRECT IN RELATION TO LICENSING OF BANKS?

(a) Supervisors shall pay due attention to the "fit and proper" testing of board and senior management, the assessment of shareholders and the ownership structure as well as the evaluation of the business plan in the course of the licensing process.

(b) Once the license has been issued to a bank, supervisory focus shall shift to other issues such as the internal processes for the identification, measurement, management and control of risks.

(c) Approval of a banking license for a bank to open a branch or a subsidiary in a foreign jurisdiction triggers the need for cooperation between the host-country supervisor considering the application for a license, and the home country supervisor where the parent undertaking is licensed.

CHAPTER 4 – OFF-SITE AND ON-SITE BANKING SUPERVISION

QUESTION 4.1: WHICH OF THE FOLLOWING STATEMENTS RELATING TO OFF-SITE AND ON-SITE SUPERVISION IS CORRECT?

(a) One of the objectives of off-site supervision is to monitor a bank's compliance with prudential limits.

(b) Off-site supervision is about the collection of quantitative information, its storage and evaluation. On-site supervision uses the information collected for peer group analysis, prioritisation of resources and takes action where necessary.

(c) Off-site and on-site supervision are complementary with off-site supervision being best suited to address quantitative elements of supervisory analysis and on-site supervision best suited for qualitative elements.

(d) Urgent on-site inspections are most efficient for the banking supervisor, because they are not announced to the bank which cannot therefore correct misdoings before the supervisor arrives to look for breaches of rules and regulations.

QUESTION 4.2: WHAT DO THE OFF-SITE SUPERVISORY TOOLS AIM TO ASSESS?

(a) The ongoing performance of banks.

(b) The current compliance of a bank with quantitative standards.

(c) A bank's past performance.

QUESTION 4.3: WHICH OF THE FOLLOWING ELEMENTS SHOULD BE PART OF THE RISK MANAGEMENT PROCESS IN A SOUND BANK?

(a) Active board and management oversight.

(b) Adequate policies and procedures.

(c) Adequate management information systems and monitoring.

(d) Strong external auditing.

(e) Comprehensive internal controls.

(f) Exposure limits.

QUESTION 4.4: WHICH OF THE FOLLOWING STATEMENTS CORRECTLY REFLECTS THE SUPERVISORY ASPECTS ASSESSED IN A "CAMEL" MODEL?

(a) Capital, Adequacy, Management, Earnings, Liability.

(b) Capital, Asset quality, Management, Earnings, Liability.

(c) Capital, Asset quality, Management, Earnings, Liquidity.

(d) Capital, Adequacy, Management, Earnings, Liquidity.

QUESTION 4.5: WHAT ARE THE THREE CORRECT PILLARS IN THE BASEL II FRAMEWORK?

(a) Capital requirements, on-site supervision of banks, disclosure.

(b) Capital adequacy, supervisory review process, disclosure and market discipline.

(c) Capital requirements, supervisory review process, disclosure and market discipline.

(d) Capital adequacy, off-site and on-site review process, market discipline.

QUESTION 4.6: WHAT ARE THE SUPERVISORY AIMS OF MOVING TO THE BASEL II FRAMEWORK?

(a) To lower the capital requirements for banks because banking supervisors have empirical evidence showing that the requirements set in Basel I were too high, affecting the efficient allocation of capital in the economy.

(b) The framework creates incentives for banks to improve their risk management and consequently to benefit from lower requirements to hold capital against risks, thereby being consistent, in essence, with the risk-based approach to supervision.

(c) To formalise the supervisory review process because Basel II allows sophisticated banks to use internal rating systems as the basis for risk management and the estimation of provisions against loan losses.

(d) By setting mandatory disclosure requirements, the framework secures comparability, thereby invoking market discipline as an instrument that can assist the supervisor in maintaining a safe and sound banking environment.

CHAPTER 5 – CRISIS MANAGEMENT AND BANK REHABILITATION

QUESTION 5.1: WHAT IS THE BASEL COMMITTEE'S DEFINITION OF A WEAK BANK?

(a) A weak bank is one which has breached prudential requirements and which requires particular supervisory attention.

(b) A weak bank is one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic direction, risk management capabilities and/or quality of management.

(c) A weak bank is one where management has failed to adequately implement the Basel II requirements and secure adequate processes for the identification, measurement, management and control of risks.

QUESTION 5.2: WHAT ARE THE CAUSES AND SYMPTOMS OF WEAKNESSES IN A BANK?

(a) Strategic failures, risk management failures, regulatory violations and fraud as well as exogenous factors are typical causes of bank failures.

(b) Strategic failures, a lack of profitability and poor asset quality are causes of bank failures.

(c) A lack of profitability, insufficient capital, poor asset management, insufficient internal processes for risk management and a lack of attention to prudential requirements are symptoms of weaknesses.

(d) A lack of profitability, insufficient capital, poor asset quality and liquidity problems are symptoms of weaknesses.

QUESTION 5.3: WHAT IS THE AIM OF THE INTERNATIONALLY SHARED PRINCIPLES FOR BANK CRISIS RESOLUTION?

(a) To preserve public confidence in the financial system.

(b) To protect the banking supervisor against public or private interference in the implementation of its mandate.

(c) To minimise disruption to the productive system (the real economy).

(d) To protect depositors and creditors against losses.

(e) To avoid disruption to the payment and securities settlement system.

(f) To prevent difficulties at one institution from affecting other institutions and leading to system instability (the domino effect).

QUESTION 5.4: WHAT ROLE CAN A DEPOSIT INSURANCE SYSTEM PLAY IN CRISIS MANAGEMENT AND BANK REHABILITATION?

(a) Deposit insurance systems can play a role in building public confidence in the banking system, thereby preventing a crisis from occurring.

(b) Deposit insurance systems can reduce the burden on taxpayers in banking crises by acquiring failed banks and running them efficiently.

(c) Deposit insurance systems can contribute to crisis management when their intervention is less expense . . . we than covering depositors' losses in the case of the bank being forced to close.

(d) Deposit insurance systems may assist in crisis management and bank restructuring, in areas such as mergers and acquisitions or purchase and assumption transactions, or in reimbursing depositors in the case of piecemeal liquidation.

CHAPTER 6 – MONEY LAUNDERING PREVENTION

QUESTION 6.1: WHAT ARE THE TERMS USED FOR THE THREE MAIN STAGES OF MONEY LAUNDERING?

(a) Placement, integration and filtration

(b) Placement, layering and integration

(c) Introduction, layering and integration

(d) Placement, lying and integration.

QUESTION 6.2: HOW CAN BANKS PROTECT THEMSELVES AGAINST BEING USED BY MONEY LAUNDERERS?

(a) Banks should not open accounts for customers with a high-profile position, because the risk of money laundering is much higher than for other types of customers.

(b) Banks cannot protect themselves against money launderers because the latter have very sophisticated, professional advisors and hide behind complex company structures that do not allow the bank to properly identify the customer.

(c) Banks should develop computer systems that allow them to block transactions on bank accounts above a certain threshold set in accordance with the customer's regular income. Should transactions above the threshold occur, the bank should confiscate the money and report the transaction and customer to the local police.

(d) Banks should have policies and processes in place that allow them to identify suspicious customers and suspicious transactions.

QUESTION 6.3: WHAT IS A SUSPICIOUS TRANSACTION?

(a) It is a financial transaction that causes reasonable suspicion that it could be related to money laundering or the financing of terrorists.

(b) It is a financial or non-financial transaction showing clear signs that it could relate to money laundering or the financing of terrorists.

(c) It is a financial transaction related to money laundering activity or the financing of terrorists.

QUESTION 6.4: HOW CAN SUPERVISORS MONITOR WHETHER BANKS ADHERE TO THE INTERNATIONAL STANDARDS FOR THE PREVENTION OF MONEY LAUNDERING?

(a) It is very difficult for the banking supervisor to monitor whether banks adhere to the international standards for the prevention of money laundering and it is not the role of the supervisor to be involved in such issues because they cannot damage the bank or its operations.

(b) The supervisor can check whether the bank has developed a "know your customer" policy that entails a customer acceptance policy, taking into account the risk profile of each customer, and that customers are monitored on an ongoing basis to identify transactions that do not follow the normal pattern of the customer and that are therefore suspicious.

(c) The supervisor can check that the bank has formally signed a contract with the Financial Action Task Force agreeing that it will adhere to its 40 recommendations.

CHAPTER 7 – FINANCIAL STABILITY MONITORING

QUESTION 7.1: WHAT IS FINANCIAL STABILITY?

(a) One of the definitions of financial stability in this book is a situation where bank failures do not occur in a national banking system.

(b) One of the definitions of financial stability in this book is a situation where the national banking system is stable, profitable and in full compliance with national laws and regulations and adheres to all the sound principles for risk management issued by the Basel Committee.

(c) One of the definitions of financial stability in this book is a condition where the financial system is able to withstand shocks without giving way to cumulative processes which impair the allocation of savings into investments and the processing of payments in the economy.

QUESTION 7.2: WHAT CHARACTERISES THE FRAMEWORK FOR FINANCIAL STABILITY ANALYSIS AND MONITORING?

(a) In G-10 countries one single, agreed framework for financial stability analysis and monitoring has existed since 2004. The framework was developed by the Financial Stability Forum and is supported by the International Monetary Fund, which has published a set of financial stability indicators as a cornerstone of the framework.

(b) No single framework for financial stability analysis and monitoring exists today. Furthermore, the definition of financial stability differs from country to country, and also from institution to institution. Financial stability analysis and monitoring is thereby gradually taking shape with many central banks, supervisors and academics contributing to the refinement of this type of analysis.

QUESTION 7.3: WHICH TOOLS AND ELEMENTS CAN BE USED IN FINANCIAL STABILITY ANALYSIS AND MONITORING?

(a) Tools and elements for financial stability analysis and monitoring are included in the International Monetary Fund's Financial Stability Indicators.

(b) Micro-prudential and macro-prudential analyses are complementary elements to be considered in financial stability analysis and monitoring.

(c) All financial intermediaries, organised and informal markets, payment and settlement networks, technical infrastructures supporting financial activity, legal and regulatory provisions, and supervisory agencies are elements to consider when analysing the financial system and its stability.

(d) In safeguarding financial stability, the monitoring and analysis of macroeconomic conditions, financial markets, financial institutions and the financial infrastructure are useful starting points.

ANNEX 3

LIST OF USEFUL WEBSITES

RUSSIA

Central Bank of the Russian Federation, http://www.cbr.ru/eng/
Finance Ministry of the Russian Federation, http://www.minfin.ru
Deposit Insurance Agency, http://www.asv.org.ru

EU (IN ALPHABETICAL ORDER)

Council of the European Union, http://ue.eu.int/cms3_fo/showPage.ASP?lang=en
European Central Bank, http://www.ecb.int/
European Commission, http://europa.eu.int/comm/index_en.htm
European Parliament, http://www.europarl.eu.int/home/default_en.htm
European Union, http://europa.eu.int/index_en.htm
– EU law, http://europa.eu.int/eur-lex/lex/en/index.htm
Delegation of the European Commission to Russia, http://www.delrus.cec.eu.int/en/

EU NATIONAL CENTRAL BANKS AND BANKING SUPERVISORS[1]

BELGIUM
Nationale Bank van België/Banque Nationale de Belgique, http://www.bnb.be/
Commissie voor het Bank-, Financie- en Assurantiewesen/Commission Bancaire, Financière et des Assurances, http://www.cbfa.be/

CZECH REPUBLIC
Česká národní banka, http://www.cnb.cz/

DENMARK
Danmarks Nationalbank, http://www.nationalbanken.dk/
Finanstilsynet, http://www.ftnet.dk/

GERMANY
Deutsche Bundesbank, http://www.bundesbank.de/
Bundesanstalt für Finanzdienstleistungsaufsicht, http://www.bafin.de/

ESTONIA
Eesti Pank, http://www.eestipank.info/
Finantsinspektsioon, http://www.fi.ee

GREECE
Bank of Greece, http://www.bankofgreece.gr/

SPAIN
Banco de España, http://www.bde.es/

FRANCE
Banque de France, http://www.banque-france.fr/
Commission bancaire, http://www.banque-france.fr/

1 In accordance with Community practice, the countries are listed here using the alphabetical order of the country names in the national languages.

IRELAND
Central Bank and Financial Services Authority of Ireland, http://www.centralbank.ie/
Irish Financial Services Regulatory Authority, http://www.ifsra.ie/

ITALY
Banca d'Italia, http://www.bancaditalia.it/

CYPRUS
Central Bank of Cyprus, http://www.centralbank.gov.cy/

LATVIA
Latvijas Banka, http://www.bank.lv/
Finanšu un kapitāla tirgus komisija, http://www.fktk.lv/

LITHUANIA
Lietuvos bankas, http://www.lb.lt/

LUXEMBOURG
Banque centrale du Luxembourg, http://www.bcl.lu/
Commission de Surveillance du Secteur Financier, http://www.cssf.lu/

HUNGARY
Magyar Nemzeti Bank, http://www.mnb.hu/
Pénzügyi Szervezetek Állami Felügyelete, http://www.pszaf.hu/

MALTA
Central Bank of Malta, http://www.centralbankmalta.com/
Malta Financial Services Authority, http://www.mfsa.com.mt/

THE NETHERLANDS
De Nederlandsche Bank, http://www.dnb.nl/

AUSTRIA
Oesterreichische Nationalbank, http://www.oenb.at/
Finanzmarktaufsicht, http://www.fma.gv.at/

POLAND
Narodowy Bank Polski, http://www.nbp.pl/

PORTUGAL
Banco de Portugal, http://www.bportugal.pt/

SLOVENIA
Banka Slovenije, http://www.bsi.si/

SLOVAKIA
Národná banka Slovenska, http://www.nbs.sk/

FINLAND
Suomen Pankki – Finlands Bank, http://www.bof.fi/
Rahoitustarkastus – Finansinspektionen, http://www.rahoitustarkastus.fi/

SWEDEN
Sveriges Riksbank, http://www.riksbank.se/
Finansinspektionen, http://www.fi.se/

UNITED KINGDOM

Bank of England, http://www.bankofengland.co.uk/
Financial Services Authority, http://www.fsa.gov.uk/

OTHER WEBSITES (ALPHABETICAL ORDER)

Basel Committee on Banking Supervision, http://www.bis.org/bcbs/index.htm
Committee of European Banking Supervisors, http://www.c-ebs.org/
Financial Action Task Force, http://www.fatf-gafi.org/
Financial Stability Forum, http://www.fsforum.org/
Financial Stability Institute, http://www.bis.org/fsi/index.htm
International Accounting Standards Board, http://www.iasb.org/
International Monetary Fund, http://www.imf.org/
International Organization of Securities Commissions, http://www.iosco.org/
Organisation for Economic Co-operation and Development, http://www.oecd.org
World Bank, http://www.worldbank.org/

ANNEX 4

BRIEF ENGLISH-RUSSIAN GLOSSARY OF BANKING SUPERVISION TERMS*

(to) Absorb losses – поглощать убытки
accounting – (финансовая) отчетность
adequacy (of reserves, capital, etc.) – достаточность (резервов, капитала и т.п.)
asset – актив
  aggregate assets – совокупные активы
  assets and liabilities – активы и обязательства
allowance – резерв (на покрытие безнадежного долга)
"arm's length" (on an arm's length basis) – «на расстоянии вытянутой руки», на общих основаниях [*т.е. между хорошо осведомленными и независимыми др. от др. участниками*]
authorization of banks – предоставление разрешения на банковскую деятельность; регистрация и лицензирование банков

Bank for International Settlements (BIS) – Банк международных расчетов
banking book – банковский портфель [активов]
  banking book assets – активы, учитываемые в банковском портфеле
Basel Capital Accord – Базельское соглашение по капиталу (1988); Базель I
Basel Core Principles (see: Core Principles for Effective Banking Supervision) – Базельские основополагающие принципы («Основополагающие принципы эффективного банковского надзора» БКБН)
board of directors – совет директоров
borrower – заемщик
branch (office) – филиал
business laws – законы о предпринимательской деятельности

Capital – капитал
  capital adequacy – достаточность капитала
  capital base – капитальная база
  capital charge – требования к капиталу для покрытия риска потерь
  capital elements/~ components – компоненты (составляющие) капитала
  capital ratio – достаточность капитала
  capital requirements – достаточность капитала
carrying amount (of assets) – балансовая стоимость (активов)
cash flow – поток денежных средств
(to) charge off – списывать (неблагополучный кредит)
charge-off – списание
claims – требования
collateral – залог
commissions – комиссионные
(to) commit funds – выделять фонды / расходовать средства
commitments – принятые обязательства
compliance – соблюдение (нормативов, правил)
  compliance supervision – надзор за выполнением [банком] установленных требований
concentration within the portfolio – концентрация (рисков) в портфеле
connected customers – связанные клиенты
connected lending – кредитование связанных заемщиков
consolidated supervision – надзор на консолидированной основе
contagion – «заражение» [*распространение отрицательных влияний на другие части рынка и т.п.*]

* Editor of Annex 4: I. Zubanova, Senior Linguist of the TACIS project.

contingent liabilities – условные обязательства
(to) control risks – держать риски под контролем / ограничивать уровень рисков
Core Principles for Effective Banking Supervision – «Основополагающие принципы эффективного банковского надзора»
corporate governance – корпоративное управление
corporate purpose – корпоративные/уставные цели (компании)
corrective action – корректирующие меры, меры воздействия
costs – расходы
  operating costs – операционные расходы
  staff costs – расходы на содержание персонала
counterparty risk – риск на контрагента
country risk – страновой риск
credit – кредит; кредитование
  granting of credit – предоставление кредита
  credit institution (CI) – кредитная организация (КО)
  credit risk – кредитный риск
creditworthiness – кредитоспособность
cross-border banking – трансграничная банковская деятельность

Debt – долг, задолженность, долговые обязательства
deduction – списание; уменьшение; вычитание
default – дефолт; невыплата по кредитным обязательствам; неплатеж
deposit – вклад, депозит
  deposit insurance – страхование вкладов
  deposit guarantee scheme – система / схема гарантирования вкладов
depositor – вкладчик
derivative – производный финансовый инструмент; дериватив
devolution – передача прав
discounting – дисконтирование
doubtful loan – сомнительный кредит
duration – дюрация; срок; продолжительность

Eligible capital – капитал, признаваемый приемлемым (для покрытия убытков)
(to) enforce penalties – вводить санкции
enforcement – применение мер воздействия
equity (capital) – акционерный капитал; собственные средства
  equity holdings – вложения в акционерный капитал
exit (of problem banks) from the market – выведение/уход (проблемных банков) с рынка; ликвидация (проблемных банков)
exposure – риск
  exposure to a single borrower – риск на одного заемщика
  large exposure – крупный кредитный риск

(to) Fail (about a bank) – потерпеть банкротство (о банке)
fair value – обоснованная стоимость
fees – плата за услуги
financial projections – финансовый прогноз
financial stability – финансовая устойчивость
fit and proper test – проверка на соответствие квалификационным требованиям
“four eyes” principle – принцип «четырех глаз»

G-7 (G-8) – Большая семерка (~ восьмерка)
G-10 – Группа десяти [*страны Базельского комитета*]
general provisions – общие резервы
guarantee – гарантия

(to) Hold capital against risks – резервировать капитал / располагать капиталом на покрытие рисков
home country – страна происхождения
host country – страна пребывания
household – домохозяйство

(to) Identify risk – выявлять риск
impairment – неблагополучие
impaired credit – неблагополучный кредит
income – доходы
(to) incur risks – подвергаться рискам
industry exposure – отраслевой риск
(to) inhibit supervision – препятствовать осуществлению надзора
initial capital – первоначальный капитал
inspection – (инспекционная) проверка; инспектирование
interest income – процентные доходы
internal controls – система внутреннего контроля
internationally active banks – транснациональные банки / международно активные банки

Large exposure – крупный кредитный риск
lender – заимодавец, кредитор
lending – кредитование, предоставление кредитов
letter of comfort – письмо-поручительство
liable capital – обеспечивающий (обязательства) капитал
license – лицензия
licensing – лицензирование
loan – кредит, ссуда
  loan loss provisions / reserves – резервы на возможные потери по ссудам
  loan officer – сотрудник кредитного подразделения банка
  l**oan portfolio** – кредитный портфель
  loans to enterprises and individuals – кредиты предприятиям и населению
  (to) grant / extend loans – предоставлять ссуды /кредиты

Macro-prudential analysis – макропруденциальный анализ
management board (of a bank) – исполнительный орган (кредитной организации)
(to) manage risks – управлять рисками
manual – инструкция, указания
market risk(s) – рыночный риск (и)
means of payment – средства платежа
(to) measure risks – измерять /оценивать риски
micro-prudential analysis – микропруденциальный анализ
minimum capital adequacy ratio – коэффициент минимального уровня достаточности капитала
(to) mitigate risks – снижать риски
(to) mobilize savings – привлекать сбережения

Non-interest income – непроцентные доходы
non-performing loan – неработающий / необслуживаемый кредит
notice / notification – уведомление

Obligations to pay – обязательства к оплате
ongoing supervision – текущий надзор
off-balance instrument – внебалансовый инструмент
off-site supervision – дистанционный (документарный) надзор
on-site inspection – инспектирование; инспекционная проверка
operating costs – операционные расходы
operating income – операционные доходы

operational independence – операционная самостоятельность
outstanding amount (of a loan) – непогашенная сумма кредита
outstanding shares – выпущенные и находящиеся в обращении акции
oversight – надзор (со стороны руководства и т.п.)
own funds – собственные средства

Participating interests – доли участия
past due loan – просроченный кредит
peer group – группа однородных организаций
policy loan [*guaranteed by government for public policy reasons*] – кредит, выданный на общественно значимые программы под гарантии правительства
policies, practices and procedures – правила, нормы и процедуры
portfolio loan – портфельный кредит
present value – текущая стоимость
professional judgment – мотивированное суждение
profitability – рентабельность
profits – финансовый результат
***pro forma* financial statement** – предварительный финансовый отчет
provision(s) – резерв(ы)
general provisions – общие резервы
specific provisions – специальные резервы [*на покрытие конкретных убытков*]
prudent management – разумное управление
prudential regulations – пруденциальные нормы
prudential requirements – пруденциальные требования
public debt – государственные долговые ценные бумаги; государственный долг
public safety net – государственная «сеть безопасности»

Qualifying holding – квалифицированная доля участия в капитале [*участие в капитале компании путем владения прямо или косвенно 10% или более капитала или прав голоса, либо иным образом позволяющее оказывать существенное влияние на решения органов управления компании*]
qualitative regulations – нормы регулирования, содержащие требования качественного характера
quantitative regulations – нормы регулирования, содержащие требования количественного характера

(to) Recover credit – возмещать/получать назад кредит
recoverable amount of credit – возместимая часть кредита
regional branch network – сеть региональных отделений, филиальная сеть
register – реестр
registered capital – уставной капитал
regulation – регулирование; нормативный акт
regulatory capital – нормативный/регулятивный капитал
regulatory framework – нормативная база
rehabilitation – финансовое оздоровление
related companies – связанные (между собой) компании
reserves against risks – резервы на покрытие рисков
retail (banking) market – рынок (банковских) услуг для населения
retained earnings – нераспределенная прибыль
(to) revoke a license – отзывать лицензию
risk-based supervision – риск-фокусированный/риск-ориентированный надзор
risk profile (of a bank) – уровень и виды рисков (банка)
risk-taking – принятие риска
risk-weighted assets – активы, взвешенные по риску

Safety and soundness – безопасность и надежность
solvency – платежеспособность
specific provisions – специальные резервы [*на покрытие конкретных убытков*]
standard-setting – разработка стандартов
stress-test – сценарий худшего варианта; стресс-тест
subordinate capital – «подчиненный» капитал
subordinated debt – субординированные заимствования
subordinate loan – субординированный кредит
subsidiary – дочерняя организация (банк и т.п.)
supervision – надзор
supervision on a consolidated basis – надзор на консолидированной основе
supervision on a solo basis – надзор на соло/неконсолидированной основе
supervisory powers of a central bank – надзорные полномочия ЦБ
supervisor – надзорный орган; сотрудник надзорного органа
supervisory board – наблюдательный совет [*в банках Германии и др. стран*]
systemic protection – защита системы; системная защита

Tier 1 (2, 3) capital – капитал 1 (2, 3) уровня
tolerance of risk – допустимый уровень риска
trading book – торговый портфель [*активов*]
  trading book assets – активы, учитываемые в торговом портфеле
transfer risk – риск перевода/трансферный риск
true and fair (reporting) – достоверная (отчетность)
"Trust is good, control is better" – «Доверяй, но проверяй»

Unconditionality – безусловная доступность [*капитала для покрытия убытков*]
(to) undertake risks – принять на себя риски

Value – стоимость
  value adjustment – корректировка стоимости
  value at risk (VaR, VAR) – стоимость под риском
viability (of a bank) – жизнеспособность (банка)
vulnerability – уязвимость; неустойчивость

SOME ABBREVIATIONS

AML = anti money laundering – противодействие легализации (отмыванию) доходов, полученных преступным путем (*разг.* борьба с отмыванием преступных доходов)
BaFin = (German) Federal Agency for Financial Supervision – Немецкое федеральное агентство по банковскому надзору
BCBS = Basel Committee on Banking Supervision - Базельский комитет по банковскому надзору (БКБН)
BIS = Bank for International Settlements – Банк международных расчетов (БМР)
CAD = Capital Adequacy Directive – Директива (ЕС) о достаточности капитала
CE = current exposure – текущие риски
CEA = credit equivalent amount – эквивалент кредита
CFT = combating financing of terrorism – борьба с финансированием терроризма
CI = credit institution – кредитная организация
CO = credit organization – кредитная организация
D = duration - дюрация
DIS = deposit insurance scheme/ system – система страхования вкладов
EAD = exposure at default – объем потерь в случае дефолта/неплатежа
EC = European Commission – Европейская Комиссия (ЕК)
ECB = European Central Bank – Европейский центральный банк (ЕЦБ)
EDF = expected default frequency – ожидаемая периодичность дефолта
ESCB = European System of Central Banks – Европейская система центральных банков (ЕСЦБ)

EL = expected losses – ожидаемые убытки
EU = European Union – Европейский Союз (ЕС)
FATF = Financial Action Task Force – Группа разработки финансовых мер борьбы с отмыванием денег (ФАТФ)
FX = foreign exchange – иностранная валюта; валютно-обменные операции
FSA = Financial Services Authority (UK) – Управление финансовых услуг (Великобритания)
FSA = Financial Supervision Authority (Finland) – Управление финансового надзора (Финляндия)
FSF = Financial Stability Forum – Форум финансовой стабильности (ФФС)
IAS = International Accounting Standards - Международные стандарты бухгалтерского учета (МСБУ)
IASB = International Accounting Standards Board – Совет по международным стандартам финансовой отчетности (СМСФО)
IFRS = International Financial Reporting Standards – Международные стандарты финансовой отчетности (МСФО)
IMF = International Monetary Fund – Международный валютный фонд (МВФ)
IOSCO = International Organization of Securities Commissions – Международная организация комиссий по ценным бумагам (МОКЦБ)
IRB = internal ratings-based (approach) – подход, основанный на внутренних рейтингах *(Базель-II)*
LGD = loss given default – сумма убытков в случае дефолта/неплатежа
LTV = loan-to-value (ratio) – соотношение размера кредита и стоимости обеспечения
M = maturity – срок погашения (финансового инструмента)
MOU = Memorandum of Understanding – меморандум о взаимопонимании
MUM = Monetary Union Member – (страна-) участница валютного союза; страна еврозоны
PD = probability of default – вероятность дефолта/неплатежа
PFE = potential future exposure – потенциальный будущий риск
PSE = public sector entities – предприятия государственного сектора
ROA = return on assets – рентабельность активов
ROE = return on equity – рентабельность капитала
UL = unexpected loss – неожидаемые убытки
VAR, VaR = value at risk (model) – (модель) стоимости под риском
WB = World Bank – Всемирный банк (ВБ)

ANNEX 5

DIRECTIVE 2000/12/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 20 MARCH 2000 RELATING TO THE TAKING UP AND PURSUIT OF THE BUSINESS OF CREDIT INSTITUTIONS*

This annex contains a replication of the above mentioned directive.

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular the first and third sentences of Article 47(2) thereof,

Having regard to the proposal from the Commission,

Having regard to the opinion of the Economic and Social Committee[1],

Acting in accordance with the procedure laid down in Article 251 of the Treaty[2],

Whereas:

(1) Council Directive 73/183/EEC of 28 June 1973 on the abolition of restrictions on freedom of establishment and freedom to provide services in respect of self-employed activities of banks and other financial institutions[3], first Council Directive (77/780/EEC) of 12 December 1977 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions[4], Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions[5], second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions6, Council Directive 89/647/EEC of 18 December 1989 on a solvency ratio for credit institutions[7], Council Directive 92/30/EEC of 6 April 1992 on the supervision of credit institutions on a consolidated basis[8], and Council Directive 92/121/EEC of 21 December 1992 on the monitoring and control of large exposures of credit institutions[9] have been frequently and substantially amended. For reasons of clarity and rationality, the said Directives therefore, should be codified and combined in a single text.

(2) Pursuant to the Treaty, any discriminatory treatment with regard to establishment and to the provision of services, based either on nationality or on the fact that an undertaking is not established in the Member State where the services are provided, is prohibited.

(3) In order to make it easier to take up and pursue the business of credit institutions, it is necessary to eliminate the most obstructive differences between the laws of the Member States as regards the rules to which these institutions are subject.

(4) This Directive constitutes the essential instrument for the achievement of the internal market, a course determined by the Single European Act and set out in timetable form in the Commission's White Paper, from the point of view of both the freedom of establishment and the freedom to provide financial services, in the field of credit institutions.

(5) Measures to coordinate credit institutions must, both in order to protect savings and to create equal conditions of competition between these institutions, apply to all of them. Due regard must

* Official Journal L 126 , 26/05/2000 P. 0001–0059

1 OJ C 157, 25.5.1998, p. 13.

2 Opinion of the European Parliament of 18 January 2000 (not yet published in the Official Journal) and Council Decision of 13 March 2000 (not yet published in the Official Journal).

3 OJ L 194, 16.7.1973, p. 1.

4 OJ L 322, 17.12.1977, p. 30. Directive as last amended by Directive 98/33/EC (OJ L 204, 21.7.1998, p. 29).

5 OJ L 124, 5.5.1989, p. 16. Directive as last amended by Directive 92/30/EEC (OJ L 110, 28.4.1992, p. 52).

6 OJ L 386, 30.12.1989, p. 1. Directive as last amended by Directive 95/26/EC (OJ L 168, 18.7.1995, p. 7).

7 OJ L 386, 30.12.1989, p. 14. Directive as last amended by Directive 98/33/EC.

8 OJ L 110, 28.4.1992, p. 52.

9 OJ L 29, 5.2.1993, p. 1. Directive as amended by the 1994 Act of Accession.

be had, where applicable, to the objective differences in their statutes and their proper aims as laid down by national laws.

(6) The scope of those measures should therefore be as broad as possible, covering all institutions whose business is to receive repayable funds from the public, whether in the form of deposits or in other forms such as the continuing issue of bonds and other comparable securities and to grant credits for their own account. Exceptions must be provided for in the case of certain credit institutions to which this Directive cannot apply. The provisions of this Directive shall not prejudice the application of national laws which provide for special supplementary authorisations permitting credit institutions to carry on specific activities or undertake specific kinds of operations.

(7) The approach which has been adopted is to achieve only the essential harmonisation necessary and sufficient to secure the mutual recognition of authorisation and of prudential supervision systems, making possible the granting of a single licence recognised throughout the Community and the application of the principle of home Member State prudential supervision. Therefore, the requirement that a programme of operations must be produced should be seen merely as a factor enabling the competent authorities to decide on the basis of more precise information using objective criteria. A measure of flexibility may none the less be possible as regards the requirements on the legal form of credit institutions of the protection of banking names.

(8) Equivalent financial requirement for credit institutions are necessary to ensure similar safeguards for savers and fair conditions of competition between comparable groups of credit institutions. Pending further coordination, appropriate structural ratios should be formulated that will make it possible within the framework of cooperation between national authorities to observe, in accordance with standard methods, the position of comparable types of credit institutions. This procedure should help to bring about the gradual approximation of the systems of coefficients established and applied by the Member States. It is necessary, however to make a distinction between coefficients intended to ensure the sound management of credit institutions and those established for the purposes of economic and monetary policy.

(9) The principles of mutual recognition and home Member State supervision require that Member States' competent authorities should not grant or should withdraw authorisation where factors such as content of the activities programmes, the geographical distribution or the activities actually carried on indicate clearly that a credit institution has opted for the legal system of one Member State for the purpose of evading the stricter standards in force in another Member State within whose territory it carries on or intends to carry on the greater part of its activities. A credit institution which is a legal person must be authorised in the Member State in which it has its registered office. A credit institution which is not a legal person must have its head office in the Member State in which it has been authorised. In addition, Member States must require that a credit institution's head office always be situated in its home Member State and that it actually operates there.

(10) The competent authorities should not authorise or continue the authorisation of a credit institution where they are liable to be prevented from effectively exercising their supervisory functions by the close links between that institution and other natural or legal persons. Credit institutions already authorised must also satisfy the competent authorities in that respect. The definition of "close links" in this Directive lays down minimum criteria. That does not prevent Member States from applying it to situations other than those envisaged by the definition. The sole fact of having acquired a significant proportion of a company's capital does not constitute participation, within the meaning of "close links", if that holding has been acquired solely as a temporary investment which does not make it possible to exercise influence over the structure or financial policy of the institution.

(11) The reference to the supervisory authorities' effective exercise of their supervisory functions covers supervision on a consolidated basis which must be exercised over a credit institution where the provisions of Community law so provide. In such cases, the authorities applied to for authorisation must be able to identify the authorities competent to exercise supervision on a consolidated basis over that credit institution.

(12) The home Member State may also establish rules stricter than those laid down in Article 5 (1), first subparagraph and (2), and Articles 7, 16, 30, 51 and 65 for institutions authorised by its competent authorities.

(13) The abolition of the authorisation requirement with respect to the branches of Community credit institutions necessitates the abolition of endowment capital.

(14) By virtue of mutual recognition, the approach chosen permits credit institutions authorised in their home Member States to carry on, throughout the Community, any or all of the activities listed in Annex I by establishing branches or by providing services. The carrying-on of activities not listed in the said Annex enjoys the right of establishment and the freedom to provide services under the general provisions of the Treaty.

(15) It is appropriate, however to extend mutual recognition to the activities listed in Annex I when they are carried on by financial institutions which are subsidiaries of credit institutions, provided that such subsidiaries are covered by the consolidated supervision of their parent undertakings and meet certain strict conditions.

(16) The host Member State may, in connection with the exercise of the right of establishment and the freedom to provide services, require compliance with specific provisions of its own national laws or regulations on the part of institutions not authorised as credit institutions in their home Member States and with regard to activities not listed in Annex I provided that, on the one hand, such provisions are compatible with Community law and are intended to protect the general good and that, on the other hand, such institutions or such activities are not subject to equivalent rules under this legislation or regulations of their home Member States.

(17) The Member States must ensure that there are no obstacles to carrying on activities receiving mutual recognition in the same manner as in the home Member State, as long as the latter do not conflict with legal provisions protecting the general good in the host Member State.

(18) There is a necessary link between the objective of this Directive and the liberalisation of capital movements being brought about by other Community legislation. In any case the measures regarding the liberalisation of banking services must be in harmony with the measures liberalising capital movements.

(19) The rules governing branches of credit institutions having their head office outside the Community should be analogous in all Member States. It is important at the present time to provide that such rules may not be more favourable than those for branches of institutions from another Member State. It should be specified that the Community may conclude agreements with third countries providing for the application of rules which accord such branches the same treatment throughout its territory, account being taken of the principle of reciprocity. The branches of credit institutions authorised in third countries do not enjoy the freedom to provide services under the second paragraph of Article 49 of the Treaty or the freedom of establishment in Member States other than those in which they are established. However, requests for the authorisation of subsidiaries or of the acquisition of holdings made by undertakings governed by the laws of third countries are subject to a procedure intended to ensure that Community credit institutions receive reciprocal treatment in the third countries in question.

(20) The authorisations granted to credit institutions by the competent national authorities pursuant to this Directive have Community-wide, and no longer merely nationwide, application. Existing reciprocity clauses have therefore no effect. A flexible procedure is therefore needed to make it possible to assess reciprocity on a Community basis. The aim of this procedure is not to close the Community’s financial markets but rather, as the Community intends to keep its financial markets open to the rest of the world, to improve the liberalisation of the global financial markets in other third countries. To that end, this Directive provides for procedures for negotiating with third countries and, as a last resort, for the possibility of taking measures involving the suspension of new applications for authorisation or the restriction of new authorisations.

(21) It is desirable that agreement should be reached, on the basis of reciprocity, between the Community and third countries with a view to allowing the practical exercise of consolidated supervision over the largest possible geographical area.

(22) Responsibility for supervising the financial soundness of a credit institution, and in particular its solvency, rests with the competent authorities of its home Member State. The host Member State's competent authorities retain responsibility for the supervision of liquidity and monetary policy. The supervision of market risk must be the subject of close cooperation between the competent authorities of the home and host Member States.

(23) The smooth operation of the internal banking market requires not only legal rules but also close and regular cooperation between the competent authorities of the Member States. For the consideration of problems concerning individual credit institutions the "groupe de contact" (contact group) set up between the banking supervisory authorities remains the most appropriate forum. That group is a suitable body for the mutual exchange of information provided for in Article 28.

(24) That mutual information procedure does not in any case replace the bilateral collaboration established by Article 28. The competent host Member State authorities can, without prejudice to their powers of proper control, continue either, in an emergency, on their own initiative or following the initiative of the competent home Member State authorities, to verify that the activities of a credit institution established within their territories comply with the relevant laws and with the principles of sound administrative and accounting procedures and adequate internal control.

(25) It is appropriate to allow the exchange of information between the competent authorities and authorities or bodies which, by virtue of their function, help to strengthen the stability of the financial system. In order to preserve the confidential nature of the information forwarded, the list of addressees must remain within strict limits.

(26) Certain behaviour, such as fraud and insider offences, is liable to affect the stability, including the integrity, of the financial system, even when involving institutions other than credit institutions.

(27) It is necessary to specify the conditions under which such exchanges of information are authorised.

(28) Where it is stipulated that information may be disclosed only with the express agreement of the competent authorities, these may, where appropriate, make their agreement subject to compliance with strict conditions.

(29) Exchanges of information between, on the one hand, the competent authorities and, on the other, central banks and other bodies with a similar function in their capacity as monetary authorities and, where appropriate, other public authorities responsible for supervising payment systems should also be authorised.

(30) For the purpose of strengthening the prudential supervision of credit institutions and protection of clients of credit institutions, it should be stipulated that an auditor must have a duty to report promptly to the competent authorities, wherever, as provided for by this Directive, he becomes aware, while carrying out his tasks, of certain facts which are liable to have a serious effect on the financial situation or the administrative and accounting organisation of a credit institution. Having regard to the aim in view, it is desirable for the Member State to provide that such a duty should apply in all circumstances where such facts are discovered by an auditor during the performance of his tasks in an undertaking which has close links with a credit institution. The duty of auditors to communicate, where appropriate, to the competent authorities certain facts and decisions concerning a credit institution which they discover during the performance of their tasks in a non-financial undertaking does not in itself change the nature of their tasks in that undertaking nor the manner in which they must perform those tasks in that undertaking.

(31) Common basic standards for the own funds of credit institutions are a key factor in the creation of an internal banking market since own funds serve to ensure the continuity of credit institutions and to protect savings. Such harmonisation strengthens the supervision of credit institutions and contributes to further coordination in the banking sector.

(32) Such standards must apply to all credit institutions authorised in the Community.

(33) The own funds of a credit institutions can serve to absorb losses which are not matched by a sufficient volume of profits. The own funds also serve as an important yardstick for the competent authorities, in particular for the assessment of the solvency of credit institutions and for other prudential purposes.

(34) Credit institutions, in an internal banking market, engage in direct competition with each other, and the definitions and standards pertaining to own funds must therefore be equivalent. To that end, the criteria for determining the composition of own funds must not be left solely to Member States. The adoption of common basic standards will be in the best interests of the Community in that it will prevent distortions of competition and will strengthen the Community banking system.

(35) The definition of own funds laid down in this Directive provides for a maximum of items and qualifying amounts, leaving it to the discretion of each Member State to use all or some of such items or to adopt lower ceilings for the qualifying amounts.

(36) This Directive specifies the qualifying criteria for certain own funds items, and the Member States remain free to apply more stringent provisions.

(37) At the initial stage common basic standards are defined in broad terms in order to encompass all the items making up own funds in the different Member States.

(38) According to the nature of the items making up own funds, this Directive distinguishes between on the one hand, items constituting original own funds and, on the other, those constituting additional own funds.

(39) To reflect the fact that items constituting additional own funds are not of the same nature as those constituting original own funds, the amount of the former included in own funds must not exceed the original own funds. Moreover, the amount of certain items of additional own funds included must not exceed one half of the original own funds.

(40) In order to avoid distortions of competition, public credit institutions must not include in their own funds guarantees granted them by the Member States or local authorities.

(41) Whenever in the course of supervision it is necessary to determine the amount of the consolidated own funds of a group of credit institutions, the calculation shall be effected in accordance with this Directive.

(42) The precise accounting technique to be used for the calculation of own funds, the solvency ratio, and for the assessment of the concentration of exposures must take account of the provisions of Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions[10], which incorporates certain adaptations of the provisions of Council Directive 83/349/EEC of 13 June 1983 based on Article 44(2)(g) of the Treaty on consolidated accounts[11].

(43) The provisions on own funds form part of the wider international effort to bring about approximation of the rules in force in major countries regarding the adequacy of own funds.

(44) The Commission will draw up a report and periodically examine, with the aim of tightening them, the provisions on own funds and thus achieving greater convergence on a common definition of own funds. Such convergence will allow the alignment of Community credit institutions' own funds.

(45) The provisions on solvency ratios are the outcome of work carried out by the Banking Advisory Committee which is responsible for making suggestions to the Commission with a view to coordinating the coefficients applicable in the Member States.

(46) The establishment of an appropriate solvency ratio plays a central role in the supervision of credit institutions.

10 OJ L 372, 31.12.1986, p. 1.

11 OJ L 193, 18.7.1983, p. 1. Directive as last amended by Directive 90/605/EEC (OJ L 317, 16.11.1990, p. 60).

(47) A ratio which weights assets and off-balance-sheet items according to the degree of credit risk is a particularly useful measure of solvency.

(48) The development of common standards for own funds in relation to assets and off-balance-sheet items exposed to credit risk is, accordingly, an essential aspect of the harmonisation necessary for the achievement of the mutual recognition of supervision techniques and thus the completion of the internal banking market.

(49) In that respect, the provisions on a solvency ratio must be considered in conjunction with other specific instruments also harmonising the fundamental techniques of the supervision of credit institutions.

(50) In an internal banking market, institutions are required to enter into direct competition with one another and the common solvency standards in the form of a minimum ratio prevent distortions of competition and strengthen the Community banking system.

(51) This Directive provides for different weightings to be given to guarantees issued by different financial institutions. The Commission accordingly undertakes to examine whether this Directive taken as a whole significantly distorts competition between credit institutions and insurance undertakings and, in the light of that examination, to consider whether any remedial measures are justified.

(52) Annex III lays down the treatment of off-balance-sheet items in the context of the calculation of credit institutions' capital requirements. With a view to the smooth functioning of the internal market and in particular with a view to ensuring a level playing field Member States are obliged to strive for uniform assessment of contractual netting agreements by their competent authorities. Annex III takes account of the work of an international forum of banking supervisors on the supervisory recognition of bilateral netting, in particular the possibility of calculating the own-funds requirements for certain transactions on the basis of a net rather than a gross amount provided that there are legally binding agreements which ensure that the credit risk is confined to the net amount. For internationally active credit institutions and groups of credit institutions in a wide range of third countries, which compete with Community credit institutions, the rules adopted on the wider international level will result in a refined supervisory treatment of over-the-counter (OTC) derivative instruments. This refinement results in a more appropriate compulsory capital cover taking into account the risk-reducing effects of supervisorily recognised contractual netting agreements on potential future credit risks. The clearing of OTC derivative instruments provided by clearing houses acting as a central counterparty plays an important role in certain Member States. It is appropriate to recognise the benefits from such a clearing in terms of a reduction of credit risk and related systemic risk in the prudential treatment of credit risk. It is necessary for the current and potential future exposures arising from cleared OTC derivatives contracts to be fully collateralised and for the risk of a build-up of the clearing house's exposures beyond the market value of posted collateral to be eliminated in order for cleared OTC derivatives to be granted for a transitional period the same prudential treatment as exchange-traded derivatives. The competent authorities must be satisfied as to the level of the initial margins and variation margins required and the quality of and the level of protection provided by the posted collateral. For credit institutions incorporated in the Member States, Annex III creates a similar possibility for the recognition of bilateral netting by the competent authorities and thereby offers them equal conditions of competition. The rules are both well balanced and appropriate for the further reinforcement of the application of prudential supervisory measures to credit institutions. The competent authorities in the Member States should ensure that the calculation of add-ons is based on effective rather than apparent national amounts.

(53) The minimum ratio provided for in this Directive reinforces the capital of credit institutions in the Community. A level of 8% has been adopted following a statistical survey of capital requirements in force at the beginning of 1988.

(54) The essential rules for monitoring large exposures of credit institutions should be harmonised. Member States should still be able to adopt provisions more stringent than those provided for by this Directive.

(55) The monitoring and control of a credit institution's exposures is an integral part of its supervision. Excessive concentration of exposures to a single client or group of connected clients may result in an unacceptable risk of loss. Such a situation may be considered prejudicial to the solvency of a credit institution.

(56) In an internal banking market, credit institutions are engaged in direct competition with one another and monitoring requirements throughout the Community should therefore be equivalent. To that end, the criteria applied to determining the concentration of exposures must be the subject of legally binding rules at Community level and cannot be left entirely to the discretion of the Member States. The adoption of common rules will therefore best serve the Community's interests, since it will prevent differences in the conditions of competition, while strengthening the Community's banking system.

(57) The provisions on a solvency ratio for credit institutions include a list of credit risks which may be incurred by credit institutions. That list should therefore be used also for the definition of exposures for the purposes of limits to large exposures. It is not, however, appropriate to refer on principle to the weightings or degrees of risk laid down in the said provisions. Those weightings and degrees of risk were devised for the purpose of establishing a general solvency requirement to cover the credit risk of credit institutions. In the context of the regulation of large exposures, the aim is to limit the maximum loss that a credit institution may incur through any single client or group of connected clients. It is therefore appropriate to adopt a prudent approach in which, as a general rule, account is taken of the nominal value of exposures, but no weightings or degrees of risk are applied.

(58) When a credit institution incurs an exposure to its own parent undertaking or to other subsidiaries of its parent undertaking, particular prudence is necessary. The management of exposures incurred by credit institutions must be carried out in a fully autonomous manner, in accordance with the principles of sound banking management, without regard to any considerations other than those principles. The provision of this Directive require that where the influence exercised by persons directly or indirectly holding a qualifying participation in a credit institution is likely to operate to the detriment of the sound and prudent management of that institution, the competent authorities shall take appropriate measures to put an end to that situation. In the field of large exposures, specific standards should also be laid down for exposures incurred by a credit institution to its own group, and in such cases more stringent restrictions are justified than for other exposures. More stringent restrictions need not, however be applied where the parent undertaking is a financial holding company or a credit institution or where the other subsidiaries are either credit or financial institutions or undertakings offering ancillary banking services, provided that all such undertakings are covered by the supervision of the credit institution on a consolidated basis. In such cases the consolidated monitoring of the group of undertakings allows for an adequate level of supervision, and does not require the imposition of more stringent limits on exposure. Under this approach banking groups will also be encouraged to organise their structures in such a way as to allow consolidated monitoring, which is desirable because a more comprehensive level of monitoring is possible.

(59) In order to be effective, supervision on a consolidated basis must be applied to all banking groups, including those the parent undertakings of which are not credit institutions. The competent authorities must hold the necessary legal instruments to be able to exercise such supervision.

(60) In the case of groups with diversified activities the parent undertakings of which control at least one credit institution subsidiary, the competent authorities must be able to assess the financial situation of a credit institution in such a group. Pending subsequent coordination, the Member States may lay down appropriate methods of consolidation for the achievement of the objective of this Directive. The competent authorities must at least have the means of obtaining from all undertakings within a group the information necessary for the performance of their function. Cooperation between the authorities responsible for the supervision of different financial sectors must be established in the case of groups of undertakings carrying on a range of financial activities.

(61) The Member States can, furthermore, refuse or withdraw banking authorisation in the case of certain group structures considered inappropriate for carrying on banking activities, in particular

because such structures could not be supervised effectively. In this respect the competent authorities have the powers mentioned in the first subparagraph of Article 7(1), Article 7(2), point (c) of Article 14(l), and Article 16 of this Directive, in order to ensure the sound and prudent management of credit institutions.

(62) The Member States can equally apply appropriate supervision techniques to groups with structures not covered by this Directive. If such structures become common, this Directive should be extended to cover them.

(63) Supervision on a consolidated basis must take in all activities defined in Annex I. All undertakings principally engaged in such activities must therefore be included in supervision on a consolidated basis. As a result, the definition of financial institutions must be widened in order to cover such activities.

(64) Directive 86/635/EEC, together with Directive 83/349/EEC, established the rules of consolidation applicable to consolidated accounts published by credit institutions. It is therefore possible to define more precisely the methods to be used in prudential supervision exercised on a consolidated basis.

(65) Supervision of credit institutions on a consolidated basis must be aimed at, in particular, protecting the interests of the depositors of the said institutions and ensuring the stability of the financial system.

(66) The examination of problems connected with matters covered by this Directive as well as by other Directive on the business of credit institutions requires cooperation between the competent authorities and the Commission within a banking advisory committee, particularly when conducted with a view to closer coordination. The Banking Advisory Committee of the competent authorities of the Member States does not rule out other forms of cooperation between authorities which supervise the taking up and pursuit of the business of credit institutions and, in particular, cooperation within the "groupe de contact" (contact group) set up between the banking supervisory authorities.

(67) Technical modifications to the detailed rules laid down in this Directive may from time to time be necessary to take account of new developments in the banking sector. The Commission shall accordingly make such modifications as are necessary, after consulting the Banking Advisory Committee, within the limits of the implementing powers conferred on the Commission by the Treaty. The measures necessary for the implementation of this Directive should be adopted in accordance with Council Decision 1999/468/EC of 28 June 1999 laying down the procedures for the exercise of implementing powers conferred on the Commission[12].

(68) Article 36(1) of this Directive permits joint and several commitments of borrowers in the case of credit institutions organised as cooperative societies or funds to be treated as own funds items under Article 34(2)(7). The Danish Government has expressed a strong interest in having its few mortgage credit institutions organised as cooperative societies or funds converted into public limited liability companies. In order to facilitate the conversion or to make it possible, a temporary derogation allowing them to include part of their joint and several commitments as own funds is required. This temporary derogation should not adversely affect competition between credit institutions.

(69) The application of a 20% weighting to credit institutions' holdings of mortgage bonds may unsettle a national financial market on which such instruments play a preponderant role. In this case, provisional measures are taken to apply a 10% risk weighting. The market for securitisation is undergoing rapid development. It is therefore desirable that the Commission should examine with the Member States the prudential treatment of asset-backed securities and put forward, before 22 June 1999, proposals aimed at adapting existing legislation in order to define an appropriate prudential treatment for asset-backed securities. The competent authorities may authorise a 50% weighting to assets secured by mortgages on offices or on multipurpose commercial premises until 31 December 2006. The property to which the mortgage relates must be subject to rigorous assessment criteria and regular revaluation to take account of the developments in the commercial

12 OJ L 184, 17.7.1999, p. 23.

property market. The property must be either occupied or let by the owner. Loans for property development are excluded from this 50 % weighting.

(70) In order to ensure harmonious application of the provisions on large exposures, Member States should be allowed to provide for the two-stage application of the new limits. For smaller credit institutions, a longer transitional period may be warranted inasmuch as too rapid an application of the 25% rule could reduce their lending activity too abruptly.

(71) Moreover, the harmonisation of the conditions relating to the reorganisation and winding-up of credit institutions is also proceeding.

(72) The arrangements necessary for the supervision of liquidity risks will also have to be harmonised.

(73) This Directive must no affect to obligations of the Member States concerning the deadlines for transposition set out in Annex V, Part B,

TITLE I
DEFINITIONS AND SCOPE

HAVE ADOPTED THIS DIRECTIVE:

Article 1

Definitions

For the purpose of this Directive:

1. “credit institution” shall mean an undertaking whose business is to receive deposits or other repayable funds from the public and to grant credits for its own account.

For the purposes of applying the supervision on a consolidated basis, shall be considered as a credit institution, a credit institution according to the first paragraph and any private or public undertaking which corresponds to the definition in the first paragraph and which has been authorised in a third country.

For the purposes of applying the supervision and control of large exposures, shall be considered as a credit institution, a credit institution according to the first paragraph, including branches of a credit institution in third countries and any private or public undertaking, including its branches, which corresponds to the definition in the first paragraph and which has been authorised in a third country;

2. “authorisation” shall mean an instrument issued in any form by the authorities by which the right to carry on the business of a credit institution is granted;

3. “branch” shall mean a place of business which forms a legally dependent part of a credit institution and which carries out directly all or some of the transactions inherent in the business of credit institutions; any number of places of business set up in the same Member State by a credit institution with headquarters in another Member State shall be regarded as a single branch;

4. “competent authorities” shall mean the national authorities which are empowered by law or regulation to supervise credit institutions;

5. “financial institution” shall mean an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry on one or more of the activities listed in points 2 to 12 of Annex I;

6. “home Member State” shall mean the Member State in which a credit institution has been authorised in accordance with Articles 4 to 11;

7. “host Member State” shall mean the Member State in which a credit institution has a branch or in which it provides services;

8. “control” shall mean the relationship between a parent undertaking and a subsidiary, as defined in Article 1 of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking;

9. “participation” for the purposes of supervision on a consolidated basis shall mean the ownership, direct or indirect, of 20% or more of the voting rights or capital of an undertaking;

10. “qualifiying holding” shall mean a direct or indirect holding in an undertaking which represents 10% or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of the undertaking in which a holding subsists.

11. “initial capital” shall mean capital as defined in Article 34(2)(1) and (2);

12. “parent undertaking” shall mean a parent undertaking as defined in Articles 1 and 2 of Directive 83/349/EEC.

It shall, for the purposes of supervision on a consolidated basis and control of large exposures, mean a parent undertaking within the meaning of Article 1(1) of Directive 83/349/EEC and any undertaking which, in the opinion of the competent authorities, effectively exercises a dominant influence over another undertaking;

13. "subsidiary" shall mean a subsidiary undertaking as defined in Articles 1 and 2 of Directive 83/349/EEC.

It shall, for the purposes of supervision on a consolidated basis and control of large exposures, mean a subsidiary undertaking within the meaning of Article 1(1) of Directive 83/349/EEC and any undertaking over which, in the opinion of the competent authorities, a parent undertaking effectively exercises a dominant influence.

All subsidiaries of subsidiary undertakings shall also be considered subsidiaries of the undertaking that is their original parent;

14. "Zone A" shall comprise all the Member States and all other countries which are full members of the Organisation for Economic Cooperation and Development (OECD) and those countries which have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's general arrangements to borrow (GAB). Any country which reschedules its external sovereign debt is, however, precluded from Zone A for a period of five years;

15. "Zone B" shall comprise all countries not in Zone A;

16. "Zone A credit institutions" shall mean all credit institutions authorised in the Member States, in accordance with Article 4, including their branches in third countries, and all private and public undertakings covered by the definitions in point 1, first subparagraph and authorised in other Zone A countries, including their branches;

17. "Zone B credit institutions" shall mean all private and public undertakings authorised outside Zone A covered by the definition in point 1, first subparagraph, including their branches within the Community;

18. "non-bank sector" shall mean all borrowers other than credit institutions as defined in points 16 and 17, central governments and central banks, regional governments and local authorities, the European Communities, the European Investment Bank (EIB) and multilateral development banks as defined in point 19;

19. "multilateral development banks" shall mean the International Bank for Reconstruction and Development, the International Finance Corporation, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the Council of Europe Resettlement Fund, the Nordic Investment Bank, the Caribbean Development Bank, the European Bank for Reconstruction and Development, the European Investment Fund and the Inter-American Investment Corporation;

20. "'full-risk', 'medium-risk', 'medium/low-risk' and 'low-risk' off-balance-sheet items" shall mean the items described in Article 43(2) and listed in Annex II;

21. "financial holding company" shall mean a financial institution, the subsidiary undertakings of which are either exclusively or mainly credit institutions or financial institutions, one at least of such subsidiaries being a credit institution;

22. "mixed-activity holding company" shall mean a parent undertaking, other than a financial holding company or a credit institution the subsidiaries of which include at least one credit institution;

23. "ancillary banking services undertaking" shall mean an undertaking the principal activity of which consists in owning or managing property, managing data-processing services, or any other similar activity which is ancillary to the principal activity of one or more credit institutions;

24. "exposures" for the purpose of applying Articles 48, 49 and 50 shall mean the assets and off-balance-sheet items referred to in Article 43 and in Annexes II and IV thereto, without application

of the weightings or degrees of risk there provided for; the risks referred to in Annex IV must be calculated in accordance with one of the methods set out in Annex III, without application of the weightings for counterparty risk; all elements entirely covered by own funds may, with the agreement of the competent authorities, be excluded from the definition of exposures provided that such own funds are not included in the calculation of the solvency ratio or of other monitoring ratios provided for in this Directive and in other Community acts; exposures shall not include:

– in the case of foreign exchange transactions, exposures incurred in the ordinary course of settlement during the 48 hours following payment, or

– in the case of transactions for the purchase or sale of securities, exposures incurred in the ordinary course of settlement during the five working days following payment or delivery of the securities, whichever is the earlier;

25. "group of connected clients" shall mean:

– two or more natural or legal persons who, unless it is shown otherwise, constitute a single risk because one of them, directly or indirectly, has control over the other or others or

– two or more natural or legal persons between whom there is no relationship of control as defined in the first indent but who are to be regarded as constituting a single risk because they are so interconnected that, if one of them were to experience financial problems, the other or all of the others would be likely to encounter repayment difficulties;

26. "close links" shall mean a situation in which two or more natural or legal persons are linked by:

(a) participation, which shall mean the ownership, direct or by way of control, of 20% or more of the voting rights or capital of an undertaking, or

(b) control, which shall mean the relationship between a parent undertaking and a subsidiary, in all the cases referred to in Article 1(1) and (2) of Directive 83/349/EEC, or a similar relationship between any natural or legal person and an undertaking; any subsidiary undertaking of a subsidiary undertaking shall also be considered a subsidiary of the parent undertaking which is at the head of those undertakings.

A situation in which two or more natural or legal persons are permanently linked to one and the same person by a control relationship shall also be regarded as constituting a close link between such persons.

27. "recognised exchanges" shall mean exchanges recognised by the competent authorities which:

(i) function regularly,

(ii) have rules, issued or approved by the appropriate authorities of the home country of the exchange, which define the conditions for the operation of the exchange, the conditions of access to the exchange as well as the conditions that must be satisfied by a contract before it can effectively be dealt on the exchange,

(iii) have a clearing mechanism that provides for contracts listed in Annex IV to be subject to daily margin requirements providing an appropriate protection in the opinion of the competent authorities.

Article 2

Scope

1. This Directive concerns the taking up and pursuit of the business of credit institutions. This Directive shall apply to all credit institutions.

2. Articles 25 and 52 to 56 shall also apply to financial holding companies and mixed-activity holding companies which have their head offices in the Community.

The institutions permanently excluded by paragraph 3, with the exception, however, of the Member States' central banks, shall be treated as financial institutions for the purposes of Articles 25 and 52 to 56.

3. This Directive shall not apply to:

- the central banks of Member States,
- post office giro institutions,
- in Belgium, the "Institut de Réescompte et de Garantie/Herdisconteringen Waarborginstituut",
- in Denmark, the "Dansk Eksportfinansieringsfond", the "Danmarks Skibskreditfond", and "Dansk Landbrugs Realkreditfond",
- in Germany, the "Kreditanstalt für Wiederaufbau", undertakings which are recognised under the "Wohnungsgemeinnützigkeitsgesetz" as bodies of State housing policy and are not mainly engaged in banking transactions, and undertakings recognised under that law as non-profit housing undertakings,
- in Greece, the "Ελληνική Τράπεζα Βιομηχαυικής Αυαπτύξεως,", (Elliniki Trapeza Viomichanikis Anaptyxeos), the "Ταμείο Παρακαταθηκών και Δανειων" (Tamio Parakatathikon kai Danion), and the "Ταχυδρομικό Ταμιευτήριο" (Tachidromiko Tamieftirio),
- in Spain, the "Instituto de Crédito Oficial",
- in France, the "Caisse des dépôts et consignations",
- in Ireland, credit unions and the friendly societies,
- in Italy, the "Cassa depositi e prestiti",
- in the Netherlands, the "Netherlandse Investeringsbank voor Ontwikkelingslanden NV", the "NV Noordelijke Ontwikkelingsmaatschappij", the "NV Industriebank Limburgs Instituut voor Ontwikkeling en Financiering" and the "Overijsselse Ontwikkelingsmaatschappij NV",
- in Austria, undertakings recognised as housing associations in the public interest and the "Österreichische Kontrollbank AG",
- in Portugal, "Caixas Económicas" existing on 1 January 1986 with the exception of those incorporated as limited companies and of the "Caixa Económica Montepio Geral",
- in Finland, the "Teollisen yhteistyön rahasto Oy/Fonden för industriellt samarbete AB", and the "Kera Oy/Kera Ab",
- in Sweden, the "Svenska Skeppshypotekskassan",
- in the United Kingdom, the National Savings Bank, the Commonwealth Development Finance Company Ltd, the Agricultural Mortgage Corporation Ltd, the Scottish Agricultural Securities Corporation Ltd, the Crown Agents for overseas governments and administrations, credit unions and municipal banks.

4. The Council, acting on a proposal from the Commission, which, for this purpose, shall consult the Committee referred to in Article 57 (hereinafter referred to as the "Banking Advisory Committee") shall decide on any amendments to the list in paragraph 3.

5. Credit institutions situated in the same Member State and permanently affiliated, on 15 December 1977, to a central body which supervises them and which is established in that same Member State, may be exempted from the requirements of Articles 6(1), 8 and 59 if, no later than 15 December 1979, national law provides that:

- the commitments of the central body and affiliated institutions are joint and several liabilities or the commitments of its affiliated institutions are entirely guaranteed by the central body,

– the solvency and liquidity of the central body and of all the affiliated institutions are monitored as a whole on the basis of consolidated accounts,

– the management of the central body is empowered to issue instructions to the management of the affiliated institutions.

Credit institutions operating locally which are affiliated, subsequent to 15 December 1977, to a central body within the meaning of the first subparagraph, may benefit from the conditions laid down therein if they constitute normal additions to the network belonging to that central body.

In the case of credit institutions other than those which are set up in areas newly reclaimed from the sea or have resulted from scission or mergers of existing institutions dependent or answerable to the central body, the Council, acting on a proposal from the Commission, which shall for this purpose, consult the Banking Advisory Committee, may lay down additional rules for the application of the second subparagraph including the repeal of exemptions provided for in the first subparagraph, where it is of the opinion that the affiliation of new institutions benefiting from the arrangements laid down in the second subparagraph might have an adverse effect on competition. The Council shall decide by a qualified majority.

6. A credit institution which, as defined in the first subparagraph of paragraph 5, is affiliated to a central body in the same Member State may also be exempted from the provisions of Article 5, and also Articles 40 to 51, and 65 provided that, without prejudice to the application of those provisions to the central body, the whole as constituted by the central body together with its affiliated institutions is subject to the abovementioned provisions a consolidated basis.

In case of exemption, Articles 13, 18, 19, 20(1) to (6), 21 and 22 shall apply to the whole as constituted by the central body together with its affiliated institutions.

Article 3

Prohibition for undertakings other than credit institutions from carrying on the business of taking deposits or other repayable funds from the public

The Member States shall prohibit persons or undertakings that are not credit institutions from carrying on the business of taking deposits or other repayable funds from the public. This prohibition shall not apply to the taking of deposits or other funds repayable by a Member State or by a Member State's regional or local authorities or by public international bodies of which one or more Member States are members or to cases expressly covered by national or Community legislation, provided that those activities are subject to regulations and controls intended to protect depositors and investors and applicable to those cases.

TITLE II
REQUIREMENTS FOR ACCESS TO THE TAKING UP AND PURSUIT OF THE BUSINESS OF CREDIT INSTITUTIONS

Article 4

Authorisation

Member States shall require credit institutions to obtain authorisation before commencing their activities. They shall lay down the requirements for such authorisation subject to Articles 5 to 9, and notify them to both the Commission and the Banking Advisory Committee.

Article 5

Initial capital

1. Without prejudice to other general conditions laid down by national law, the competent authorities shall not grant authorisation when the credit institution does not possess separate own funds or in cases where initial capital is less than €5 million.

Member States may decide that credit institutions which do not fulfil the requirement of separate own funds and which were in existence on 15 December 1979 may continue to carry on their business. They may exempt such credit institutions from complying with the requirement contained in the first subparagraph of Article 6(1).

2. The Member States shall, however, have the option of granting authorisation to particular categories of credit institutions the initial capital of which is less than that prescribed in paragraph 1. In such cases:

(a) the initial capital shall not be less than €1 million,

(b) the Member States concerned must notify the Commission of their reasons for making use of the option provided for in this paragraph,

(c) when the list referred to in Article 11 is published, the name of each credit institution that does not have the minimum capital prescribed in paragraph 1 shall be annotated to that effect.

3. A credit institution's own funds may not fall below the amount of initial capital required by paragraphs 1 and 2 at the time of its authorisation.

4. The Member States may decide that credit institutions already in existence on 1 January 1993, the own funds of which do not attain the levels prescribed for initial capital in paragraphs 1 and 2, may continue to carry on their activities. In that event, their own funds may not fall below the highest level reached with effect from 22 December 1989.

5. If control of a credit institution falling within the category referred to in paragraph 4 is taken by a natural or legal person other than the person who controlled the institution previously, the own funds of that institution must attain at least the level prescribed for initial capital in paragraphs 1 and 2.

6. In certain specific circumstances and with the consent of the competent authorities, where there is a merger of two or more credit institutions falling within the category referred to in paragraph 4, the own funds of the institution resulting from the merger may not fall below the total own funds of the merged institutions at the time of the merger, as long as the appropriate levels pursuant to paragraphs 1 and 2 have not been attained.

7. If, in the cases referred to in paragraphs 3, 4 and 6, the own funds should be reduced, the competent authorities may, where the circumstances justify it, allow an institution a limited period in which to rectify its situation or cease its activities.

Article 6

Management body and place of the head office of credit institutions

1. The competent authorities shall grant an authorisation to the credit institution only when there are at least two persons who effectively direct the business of the credit institution.

Moreover, the authorities concerned shall not grant authorisation if these persons are not of sufficiently good repute or lack sufficient experience to perform such duties.

2. Each Member State shall require that:

– any credit institution which is a legal person and which, under its national law, has a registered office have its head office in the same Member State as its registered office,

– any other credit institution have its head office in the Member State which issued its authorisation and in which it actually carries on its business.

Article 7

Shareholders and members

1. The competent authorities shall not grant authorisation for the taking-up of the business of credit institutions before they have been informed of the identities of the shareholders or members, whether direct or indirect, natural or legal persons, that have qualifying holdings, and of the amounts of those holdings.

For the purpose of the definition of qualifying holding in the context of this Article, the voting rights referred to in Article 7 of Council Directive 88/627/EEC[13] shall be taken into consideration.

2. The competent authorities shall refuse authorisation if, taking into account the need to ensure the sound and prudent management of a credit institution, they are not satisfied as to the suitability of the abovementioned shareholders or members.

3. Where close links exist between the credit institution and other natural or legal persons, the competent authorities shall grant authorisation only if those links do not prevent the effective exercise of their supervisory functions.

The competent authorities shall also refuse authorisation if the laws, regulations or administrative provisions of a non-member country governing one or more natural or legal persons with which the credit institution has close links, or difficulties involved in their enforcement, prevent the effective exercise of their supervisory functions.

The competent authorities shall require credit institutions to provide them with the information they require to monitor compliance with the conditions referred to in this paragraph on a continuous baswis.

Article 8

Programme of operations and structural organisation

Member States shall require applications for authorisation to be accompanied by a programme of operations setting out, inter alia, the types of business envisaged and the structural organisation of the institution.

Article 9

Economic needs

Member States may not require the application for authorisation to be examined in terms of the economic needs of the market.

13 Council Directive 88/627/EEC of 12 December 1988 on the information to be published when a major holding in a listed company is acquired or disposed of (OJ L 348, 17.12.1988, p. 62).

Article 10

Authorisation refusal

Reasons shall be given whenever an authorisation is refused and the applicant shall be notified thereof within six months of receipt of the application or, should the latter be incomplete, within six months of the applicant's sending the information required for the decision. A decision shall, in any case, be taken within 12 months of the receipt of the application.

Article 11

Notification of the authorisation to the Commission

Every authorisation shall be notified to the Commission. Each credit institution shall be entered in a list which the Commission shall publish in the Official Journal of the European Communities and shall keep up to date.

Article 12

Prior consultation with the competent authorities of other Member States

There must be prior consultation with the competent authorities of the other Member State involved on the authorisation of a credit institution which is:

- a subsidiary of a credit institution authorised in another Member State, or
- a subsidiary of the parent undertaking of a credit institution authorised in another Member State, or
- controlled by the same persons, whether natural or legal, as control a credit institution authorised in another Member State.

Article 13

Branches of credit institutions authorised in another Member State

Host Member States may not require authorisation or endowment capital for branches of credit institutions authorised in other Member States. The establishment and supervision of such branches shall be effected as prescribed in Articles 17, 20(l) to (6) and Articles 22 and 26.

Article 14

Withdrawal of authorisation

1. The competent authorities may withdraw the authorisation issued to a credit institution only where such an institution:

(a) does not make use of the authorisation within 12 months, expressly renounces the authorisation or has ceased to engage in business for more than six months, if the Member State concerned has made no provision for the authorisation to lapse in such cases;

(b) has obtained the authorisation through false statements or any other irregular means;

(c) no longer fulfils the conditions under which authorisation was granted;

(d) no longer possesses sufficient own funds or can no longer be relied on to fulfil its obligations towards its creditors, and in particular no longer provides security for the assets entrusted to it;

(e) falls within one of the other cases where national law provides for withdrawal of authorisation.

2. Reasons must be given for any withdrawal of authorisation and those concerned informed thereof; such withdrawal shall be notified to the Commission.

Article 15

Name

For the purpose of exercising their activities, credit institutions may, notwithstanding any provisions concerning the use of the words “bank”, “savings bank” or other banking names which may exist in the host Member State, use throughout the territory of the Community the same name as they use in the Member State in which their head office is situated. In the event of there being any danger of confusion, the host Member State may, for the purposes of clarification, require that the name be accompanied by certain explanatory particulars.

Article 16

Qualifiying holding in a credit institution

1. The Member States shall require any natural or legal person who proposes to hold, directly or indirectly a qualifying holding in a credit institution first to inform the competent authorities, telling them of the size of the intended holding. Such a person must likewise inform the competent authorities if he proposes to increase his qualifying holding so that the proportion of the voting rights or of the capital held by him would reach or exceed 20%, 33% or 50% or so that the credit institution would become his subsidiary.

Without prejudice to the provisions of paragraph 2, the competent authorities shall have a maximum of three months from the date of the notification provided for in the first subparagraph to oppose such a plan if, in view of the need to ensure sound and prudent management of the credit institution, they are not satisfied as to the suitability of the person referred to in the first subparagraph. If they do not oppose the plan referred to in the first subparagraph, they may fix a maximum period for its implementation.

2. If the acquirer of the holdings referred to in paragraph 1 is a credit institution authorised in another Member State or the parent undertaking of a credit institution authorised in another Member State or a natural or legal person controlling a credit institution authorised in another Member State and if, as a result of that acquisition, the institution, in which the acquirer proposes to hold a holding would become a subsidiary or subject to the control of the acquirer, the assessment of the acquisition must be the subject of the prior consultation referred to in Article 12.

3. The Member States shall require any natural or legal person who proposes to dispose, directly or indirectly, of a qualifying holding in a credit institution first to inform the competent authorities, telling them of the size of his intended holding. Such a person must likewise inform the competent authorities if he proposes to reduce his qualifying holding so that the proportion of the voting rights or of the capital held by him would fall below 20%, 33% or 50% or so that the credit institution would cease to be his subsidiary.

4. On becoming aware of them, credit institutions shall inform the competent authorities of any acquisitions or disposals of holdings in their capital that cause holdings to exceed or fall below one of the thresholds referred to in paragraphs 1 and 3.

They shall also, at least once a year, inform them of the names of shareholders and members possessing qualifying holdings and the sizes of such holdings as shown, for example, by the information received at the annual general meetings of shareholders and members or as a result of compliance with the regulations relating to companies listed on stock exchanges.

5. The Member States shall require that, where the influence exercised by the persons referred to in paragraph 1 is likely to operate to the detriment of the prudent and sound management of the institution, the competent authorities shall take appropriate measures to put an end to that situation. Such measures may consist for example in injunctions, sanctions against directors and managers, or the suspension of the exercise of the voting rights attaching to the shares held by the shareholders or members in question.

Similar measures shall apply to natural or legal persons failing to comply with the obligation to provide prior information, as laid down in paragraph 1. If a holding is acquired despite the

opposition of the competent authorities, the Member States shall, regardless of any other sanctions to be adopted, provide either for exercise of the corresponding voting rights to be suspended, or for the nullity of votes cast or for the possibility of their annulment.

6. For the purposes of the definition of qualifying holding and other levels of holding set out in this Article, the voting rights referred to in Article 7 of Directive 88/627/EEC shall be taken into consideration.

Article 17

Procedures and internal control mechanisms

Home Member State competent authorities shall require that every credit institution have sound administrative and accounting procedures and adequate internal control mechanisms.

TITLE III
PROVISIONS CONCERNING THE FREEDOM OF ESTABLISHMENT AND THE FREEDOM TO PROVIDE SERVICES

Article 18

Credit institutions

The Member States shall provide that the activities listed in Annex I may be carried on within their territories, in accordance with Articles 20(1) to (6), 21(1) and (2), and 22, either by the establishment of a branch or by way of the provision of services, by any credit institution authorised and supervised by the competent authorities of another Member State, provided that such activities are covered by the authorisation.

Article 19

Financial institutions

The Member States shall also provide that the activities listed in Annex I may be carried on within their territories, in accordance with Articles 20(1) to (6), 21(1) and (2), and 22, either by the establishment of a branch or by way of the provision of services, by any financial institution from another Member State, whether a subsidiary of a credit institution or the jointly-owned subsidiary of two or more credit institutions, the memorandum and articles of association of which permit the carrying on of those activities and which fulfils each of the following conditions:

- the parent undertaking or undertakings must be authorised as credit institutions in the Member State by the law of which the subsidiary is governed,
- the activities in question must actually be carried on within the territory of the same Member State,
- the parent undertaking or undertakings must hold 90% or more of the voting rights attaching to shares in the capital of the subsidiary.
- the parent undertaking or undertakings must satisfy the competent authorities regarding the prudent management of the subsidiary and must have declared, with the consent of the relevant home Member State competent authorities, that they jointly and severally guarantee the commitments entered into by the subsidiary,
- the subsidiary must be effectively included, for the activities in question in particular, in the consolidated supervision of the parent undertaking, or of each of the parent undertakings, in accordance with Articles 52 to 56, in particular for the calculation of the solvency ratio, for the control of large exposures and for purposes of the limitation of holdings provided for in Article 51.

Compliance with these conditions must be verified by the competent authorities of the home Member State and the latter must supply the subsidiary with a certificate of compliance which must form part of the notification referred to in Articles 20(1) to (6), and 21(1) and (2).

The competent authorities of the home Member State shall ensure the supervision of the subsidiary in accordance with Articles 5(3), 16, 17, 26, 28, 29, 30, and 32.

The provisions mentioned in this Article shall apply mutatis mutandis to subsidiaries, subject to the necessary modifications. In particular, the words "credit institution" should be read as "financial institution fulfilling the conditions laid down in Article 19" and the word "authorisation" as "memorandum and articles of association".

The second subparagraph of Article 20(3) shall read: "The home Member State competent authorities shall also communicate the amount of own funds of the subsidiary financial institution and the consolidated solvency ratio of the credit institution which is its parent undertaking".

If a financial institution eligible under this Article should cease to fulfil any of the conditions imposed, the home Member State shall notify the competent authorities of the host Member State and the activities carried on by that institution in the host Member State become subject to the legislation of the host Member State.

Article 20

Exercise of the right of establishment

1. A credit institution wishing to establish a branch within the territory of another Member State shall notify the competent authorities of its Member State.

2. The Member State shall require every credit institution wishing to establish a branch in another Member State to provide the following information when effecting the notification referred to in paragraph 1:

(a) the Member State within the territory of which it plans to establish a branch;

(b) a programme of operations setting out, inter alia, the types of business envisaged and the structural organisation of the branch;

(c) the address in the host Member State from which documents may be obtained;

(d) the names of those responsible for the management of the branch.

3. Unless the competent authorities of the home Member State have reason to doubt the adequacy of the administrative structure or the financial situation of the credit institution, taking into account the activities envisaged, they shall within three months of receipt of the information referred to in paragraph 2 communicate that information to the competent authorities of the host Member State and shall inform the institution accordingly.

The home Member State competent authorities shall also communicate the amount of own funds and the solvency ratio of the credit institution.

Where the competent authorities of the home Member State refuse to communicate the information referred to in paragraph 2 to the competent authorities of the host Member State, they shall give reasons for their refusal to the institution concerned within three months of receipt of all the information. That refusal or failure to reply shall be subject to a right to apply to the courts in the home Member State.

4. Before the branch of a credit institution commences its activities the competent authorities of the host Member State shall, within two months of receiving the information mentioned in paragraph 3, prepare for the supervision of the credit institution in accordance with Article 22 and if necessary indicate the conditions under which, in the interest of the general good, those activities must be carried on in the host Member State.

5. On receipt of a communication from the competent authorities of the host Member State, or in the event of the expiry of the period provided for in paragraph 4 without receipt of any communication from the latter, the branch may be established and commence its activities.

6. In the event of a change in any of the particulars communicated pursuant to paragraph 2(b), (c) or (d), a credit institution shall give written notice of the change in question to the competent authorities of the home and host Member States at least one month before making the change so as to enable the competent authorities of the home Member State to take a decision pursuant to paragraph 3 and the competent authorities of the host Member State to take a decision on the change pursuant to paragraph 4.

7. Branches which have commenced their activities, in accordance with the provisions in force in their host Member States, before 1 January 1993, shall be presumed to have been subject to the procedure laid down in paragraphs 1 to 5. They shall be governed, from the abovementioned date, by paragraph 6, and by Articles 18, 19, 22 and 29.

Article 21

Exercise of the freedom to provide services

1. Any credit institution wishing to exercise the freedom to provide services by carrying on its activities within the territory of another Member State for the first time shall notify the competent authorities of the home Member State, of the activities on the list in Annex I which it intends to carry on.

2. The competent authorities of the home Member State shall, within one month of receipt of the notification mentioned in paragraph 1, send that notification to the competent authorities of the host Member State.

3. This Article shall not affect rights acquired by credit institutions providing services before 1 January 1993.

Article 22

Power of the competent authorities of the host Member State

1. Host Member States may, for statistical purposes, require that all credit institutions having branches within their territories shall report periodically on their activities in those host Member States to the competent authorities of those host Member States.

In discharging the responsibilities imposed on them in Article 27, host Member States may require that branches of credit institutions from other Member States provide the same information as they require from national credit institutions for that purpose.

2. Where the competent authorities of a host Member State ascertain than an institution having a branch or providing services within its territory is not complying with the legal provisions adopted in that State pursuant to the provisions of this Directive involving powers of the host Member State's competent authorities, those authorities shall require the institution concerned to put an end to that irregular situation.

3. If the institution concerned fails to take the necessary steps, the competent authorities of the host Member State shall inform the competent authorities of the home Member State accordingly. The competent authorities of the home Member State shall, at the earliest opportunity, take all appropriate measures to ensure that the institution concerned puts an end to that irregular situation. The nature of those measures shall be communicated to the competent authorities of the host Member State.

4. If, despite the measures taken by the home Member State or because such measures prove inadequate or are not available in the Member State in question, the institution persists in violating the legal rules referred to in paragraph 2 in force in the host Member State, the latter State may, after informing the competent authorities of the home Member State, take appropriate measures to prevent or to punish further irregularities and, in so far as is necessary, to prevent that institution from initiating further transactions within its territory. The Member States shall ensure that within their territories it is possible to serve the legal documents necessary for these measures on credit institutions.

5. The provisions of paragraph 1 to 4 shall not affect the power of host Member States to take appropriate measures to prevent or to punish irregularities committed within their territories which are contrary to the legal rules they have adopted in the interest of the general good. This shall include the possibility of preventing offending institutions from initiating any further transactions within their territories.

6. Any measure adopted pursuant to paragraph 3, 4 and 5 involving penalties or restrictions on the exercise of the freedom to provide services must be properly justified and communicated to the institution concerned. Every such measure shall be subject to a right of appeal to the courts in the Member State the authorities of which adopted it.

7. Before following the procedure provided for in paragraph 2, 3 and 4, the competent authorities of the host Member State may, in emergencies, take any precautionary measures necessary to protect the interests of depositors, investors and others to whom services are provided. The Commission and the competent authorities of the other Member States concerned must be informed of such measures at the earliest opportunity.

The Commission may, after consulting the competent authorities of the Member States concerned, decide that the Member State in question must amend or abolish those measures.

8. Host Member States may exercise the powers conferred on them under this Directive by taking appropriate measures to prevent or to punish irregularities committed within their territories. This shall include the possibility of preventing institutions from initiating further transactions within their territories.

9. In the event of the withdrawal of authorisation the competent authorities of the host Member State shall be informed and shall take appropriate measures to prevent the institution concerned from initiating further transactions within its territory and to safeguard the interests of depositors. Every two years the Commission shall submit a report on such cases to the Banking Advisory Committee.

10. The Member States shall inform the Commission of the number and type of cases in which there has been a refusal pursuant to Article 20(1) to (6) or in which measures have been taken in accordance with paragraph 4 of this Article. Every two years the Commission shall submit a report on such cases to the Banking Advisory Committee.

11. Nothing in this Article shall prevent credit institutions with head offices in other Member States from advertising their services through all available means of communication in the host Member State, subject to any rules governing the form and the content of such advertising adopted in the interest of the general good.

TITLE IV
RELATIONS WITH THIRD COUNTRIES

Article 23

Notification of the subsidiaries of third countries' undertakings and conditions of access to the markets of these countries

1. The competent authorities of the Member States shall inform the Commission:

(a) of any authorisation of a direct or indirect subsidiary one or more parent undertakings of which are governed by the laws of a third country. The Commission shall inform the Banking Advisory Committee accordingly;

(b) whenever such a parent undertaking acquires a holding in a Community credit institution such that the latter would become its subsidiary. The Commission shall inform the Banking Advisory Committee accordingly.

When authorisation is granted to the direct or indirect subsidiary of one or more parent undertakings governed by the law of third countries, the structure of the group shall be specified in the notification which the competent authorities shall address to the Commission in accordance with Article 11.

2. The Member States shall inform the Commission of any general difficulties encountered by their credit institutions in establishing themselves or carrying on banking activities in a third country.

3. The Commission shall periodically draw up a report examining the treatment accorded to Community credit institutions in third countries, in the terms referred to in paragraphs 4 and 5, as regards establishment and the carrying-on of banking activities, and the acquisition of holdings in third-country credit institutions. The Commission shall submit those reports to the Council, together with any appropriate proposals.

4. Whenever it appears to the Commission, either on the basis of the reports referred to in paragraph 3 or on the basis of other information, that a third country is not granting Community credit institutions effective market access comparable to that granted by the Community to credit institutions from that third country, the Commission may submit proposals to the Council for the appropriate mandate for negotiation with a view to obtaining comparable competitive opportunities for Community credit institutions. The Council shall decide by a qualified majority.

5. Whenever it appears to the Commission, either on the basis of the reports referred to in paragraph 3 or on the basis of other information that Community credit institutions in a third country do not receive national treatment offering the same competitive opportunities as are available to domestic credit institutions and the conditions of effective market access are not fulfilled, the Commission may initiate negotiations in order to remedy the situation.

In the circumstances described in the first subparagraph, it may also be decided at any time, and in addition to initiating negotiations, in accordance with the procedure laid down in Article 60(2), that the competent authorities of the Member States must limit or suspend their decisions regarding requests pending at the moment of the decision or future requests for authorisations and the acquisition of holdings by direct or indirect parent undertakings governed by the laws of the third country in question. The duration of the measures referred to may not exceed three months.

Before the end of that three-month period, and in the light of the results of the negotiations, the Council may, acting on a proposal from the Commission, decide by a qualified majority whether the measures shall be continued.

Such limitations or suspension may not apply to the setting up of subsidiaries by credit institutions or their subsidiaries duly authorised in the Community, or to the acquisition of holdings in Community credit institutions by such institutions or subsidiaries.

6. Whenever it appears to the Commission that one of the situations described in paragraphs 4 and 5 obtains, the Member States shall inform it at its request:

(a) of any request for the authorisation of a direct or indirect subsidiary one or more parent undertakings of which are governed by the laws of the third country in question;

(b) whenever they are informed in accordance with Article 16 that such an undertaking proposes to acquire a holding in a Community credit institution such that the latter would become its subsidiary.

This obligation to provide information shall lapse whenever an agreement is reached with the third country referred to in paragraph 4 or 5 or when the measures referred to in the second and third subparagraphs of paragraph 5 cease to apply.

7. Measures taken pursuant to this Article comply with the Community's obligations under any international agreements, bilateral or multilateral, governing the taking-up and pursuit of the business of credit institutions.

Article 24

Branches of credit institutions having their head offices outside the Community

1. Member States shall not apply to branches of credit institutions having their head office outside the Community, when commencing or carrying on their business, provisions which result in more favourable treatment than that accorded to branches of credit institutions having their head office in the Community.

2. The competent authorities shall notify the Commission and the Banking Advisory Committee of all authorisations for branches granted to credit institutions having their head office outside the Community.

3. Without prejudice to paragraph 1, the Community may, through agreements concluded in accordance with the Treaty with one or more third countries, agree to apply provisions which, on the basis of the principle of reciprocity, accord to branches of a credit institution having its head office outside the Community identical treatment throughout the territory of the Community.

Article 25

Cooperation with third countries' competent authorities regarding supervision on a consolidated basis

1. The Commission may submit proposals to the Council, either at the request of a Member State or on its own initiative, for the negotiation of agreements with one or more third countries regarding the means of exercising supervision on a consolidated basis over:

– credit institutions the parent undertakings of which have their head offices situated in a third country, and

– credit institutions situated in third countries the parent undertakings of which, whether credit institutions or financial holding companies, have their head offices in the Community.

2. The agreements referred to in paragraph 1 shall in particular seek to ensure both:

– that the competent authorities of the Member States are able to obtain the information necessary for the supervision, on the basis of their consolidated financial situations, of credit institutions or financial holding companies situated in the Community and which have as subsidiaries credit institutions or financial institutions situated outside the Community, or holding participation in such institutions,

– that the competent authorities of third countries are able to obtain the information necessary for the supervision of parent undertakings the head offices of which are situated within their

territories and which have as subsidiaries credit institutions or financial institutions situated in one or more Member States or holding participation in such institutions.

3. The Commission and the Banking Advisory Committee shall examine the outcome of the negotiations referred to in paragraph 1 and the resulting situation.

TITLE V
PRINCIPLES AND TECHNICAL INSTRUMENTS FOR PRUDENTIAL SUPERVISION

CHAPTER 1

PRINCIPLES OF PRUDENTIAL SUPERVISION

Article 26

Competence of control of the home Member State

1. The prudential supervision of a credit institution, including that of the activities it carries on accordance with Articles 18 and 19, shall be the responsibility of the competent authorities of the home Member State, without prejudice to those provisions of this Directive which give responsibility to the authorities of the host Member State.

2. Paragraph 1 shall not prevent supervision on a consolidated basis pursuant to this Directive.

Article 27

Competence of the host Member State

Host Member States shall retain responsibility in cooperation with the competent authorities of the home Member State for the supervision of the liquidity of the branches of credit institutions pending further coordination. Without prejudice to the measures necessary for the reinforcement of the European Monetary System, host Member States shall retain complete responsibility for the measures resulting from the implementation of their monetary policies. Such measures may not provide for discriminatory or restrictive treatment based on the fact that a credit institution is authorised in another Member State.

Article 28

Collaboration concerning supervision

The competent authorities of the Member States concerned shall collaborate closely in order to supervise the activities of credit institutions operating, in particular by having established branches there, in one or more Member States other than that in which their head offices are situated. They shall supply one another with all information concerning the management and ownership of such credit institutions that is likely to facilitate their supervision and the examination of the conditions for their authorisation, and all information likely to facilitate the monitoring of such institutions, in particular with regard to liquidity, solvency, deposit guarantees, the limiting of large exposures, administrative and accounting procedures and internal control mechanisms.

Article 29

On-the-spot verification of branches established in another Member State

1. Host Member States shall provide that, where a credit institution authorised in another Member State carries on its activities through a branch, the competent authorities of the home Member State may, after having first informed the competent authorities of the host Member State, carry out themselves or through the intermediary of persons they appoint for that purpose on-the-spot verification of the information referred to in Article 28.

2. The competent authorities of the home Member State may also, for purposes of the verification of branches, have recourse to one of the other procedures laid down in Article 56(7).

3. This Article shall not affect the right of the competent authorities of the host Member State to carry out, in the discharge of their responsibilities under this Directive, on-the-spot verifications of branches established within their territory.

Article 30

Exchange of information and professional secrecy

1. The Member States shall provide that all persons working or who have worked for the competent authorities, as well as auditors or experts acting on behalf of the competent authorities, shall be bound by the obligation of professional secrecy. This means that no confidential information which they may receive in the course of their duties may be divulged to any person or authority whatsoever, except in summary or collective form, such that individual institutions cannot be identified, without prejudice to cases covered by criminal law.

Nevertheless, where a credit institution has been declared bankrupt or is being compulsorily wound up, confidential information which does not concern third parties involved in attempts to rescue that credit institution may be divulged in civil or commercial proceedings.

2. Paragraph 1 shall not prevent the competent authorities of the various Member States from exchanging information in accordance with this Directive and with other Directives applicable to credit institutions. That information shall be subject to the conditions of professional secrecy indicated in paragraph 1.

3. Member States may conclude cooperation agreements, providing for exchanges of information, with the competent authorities of third countries or with authorities or bodies of third countries as defined in paragraphs 5 and 6 only if the information disclosed is subject to guarantees of professional secrecy at least equivalent to those referred to in this Article. Such exchange of information must be for the purpose of performing the supervisory task of the authorities or bodies mentioned.

Where the information originates in another Member State, it may not be disclosed without the express agreement of the competent authorities which have disclosed it and, where appropriate, solely for the purposes for which those authorities gave their agreement.

4. Competent authorities receiving confidential information under paragraphs 1 or 2 may use it only in the course of their duties:

- to check that the conditions governing the taking-up of the business of credit institutions are met and to facilitate monitoring, on a non-consolidated or consolidated basis, of the conduct of such business, especially with regard to the monitoring of liquidity, solvency, large exposures, and administrative and accounting procedures and internal control mechanisms, or
- to impose sanctions, or
- in an administrative appeal against a decision of the competent authority, or
- in court proceedings initiated pursuant to Article 33 or to special provisions provided for in this in other Directives adopted in the field of credit institutions.

5. Paragraphs 1 and 4 shall not preclude the exchange of information within a Member State, where there are two or more competent authorities in the same Member State, or between Member States, between competent authorities and:

- authorities entrusted with the public duty of supervising other financial organisations and insurance companies and the authorities responsible for the supervision of financial markets,
- bodies involved in the liquidation and bankruptcy of credit institutions and in other similar procedures,
- persons responsible for carrying out statutory audits of the accounts of credit institutions and other financial institutions,

in the discharge of their supervisory functions, and the disclosure to bodies which administer deposit-guarantee schemes of information necessary to the exercise of their functions. The information received shall be subject to the conditions of professional secrecy indicated in paragraph 1.

6. Notwithstanding paragraphs 1 to 4, Member States may authorise exchanges of information between, the competent authorities and:

– the authorities responsible for overseeing the bodies, involved in the liquidation and bankruptcy of credit institutions and other similar procedures, or

– the authorities responsible for overseeing persons charged with carrying out statutory audits of the accounts of insurance undertakings, credit institutions, investment firms and other financial institutions.

Member States which have recourse to the provisions of the first subparagraph shall require at least that the following conditions are met:

– the information shall be for the purpose of performing the supervisory task referred to in the first subparagraph,

– information received in this context shall be subject to the conditions of professional secrecy imposed in paragraph 1,

– where the information originates in another Member State, it may not be disclosed without the express agreement of the competent authorities which have disclosed it and, where appropriate, solely for the purposes for which those authorities gave their agreement.

Member States shall communicate to the Commission and to the other Member States the name of the authorities which may receive information pursuant to this paragraph.

7. Notwithstanding paragraphs 1 to 4, Member States may, with the aim of strengthening the stability, including integrity, of the financial system, authorise the exchange of information between the competent authorities and the authorities or bodies responsible under law for the detection and investigation of breaches of company law.

Member States which have recourse to the provision in the first subparagraph shall require at least that the following conditions are met:

– the information shall be for the purpose of performing the task referred to in the first subparagraph,

– information received in this context shall be subject to the conditions of professional secrecy imposed in paragraph 1,

– where the information originates in another Member State, it may not be disclosed without the express agreement of the competent authorities which have disclosed it and, where appropriate, solely for the purposes for which those authorities gave their agreement.

Where, in a Member State, the authorities or bodies referred to in the first subparagraph perform their task of detection or investigation with the aid, in view of their specific competence, of persons appointed for that purpose and not employed in the public sector, the possibility of exchanging information provided for in the first subparagraph may be extended to such persons under the conditions stipulated in the second subparagraph.

In order to implement the third indent of the second subparagraph, the authorities or bodies referred to in the first subparagraph shall communicate to the competent authorities which have disclosed the information, the names and precise responsibilities of the persons to whom it is to be sent.

Member States shall communicate to the Commission and to the other Member States the names of the authorities or bodies which may receive information pursuant to this paragraph.

Before 31 December 2000, the Commission shall draw up a report on the application of the provisions of this paragraph.

8. This Article shall not prevent a competent authority from transmitting:

– to central banks and other bodies with a similar function in their capacity as monetary authorities,

– where appropriate to other public authorities responsible for overseeing payment systems,

information intended for the performance of their task, nor shall it prevent such authorities or bodies from communicating to the competent authorities such information as they may need for the purposes of paragraph 4. Information received in this context shall be subject to the conditions of professional secrecy imposed in this Article.

9. In addition, notwithstanding the provisions referred to in paragraphs 1 and 4, the Member States may, by virtue of provisions laid down by law, authorise the disclosure of certain information to other departments of their central government administrations responsible for legislation on the supervision of credit institutions financial institutions, investment services and insurance companies and to inspectors acting on behalf of those departments.

However, such disclosures may be made only where necessary for reasons of prudential control.

However, the Member States shall provide that information received under paragraphs 2 and 5 and that obtained by means of the on-the-spot verification referred to in Article 29(1) and (2) may never be disclosed in the cases referred to in this paragraph except with the express consent of the competent authorities which disclosed the information or of the competent authorities of the Member State in which on-the-spot verification was carried out.

10. This Article shall not prevent the competent authorities from communicating the information referred to in paragraphs 1 to 4 to a clearing house or other similar body recognised under national law for the provision of clearing or settlement services for one of their Member States' markets if they consider that it is necessary to communicate the information in order to ensure the proper functioning of those bodies in relation to defaults or potential defaults by market participants. The information received in this context shall be subject to the conditions of professional secrecy imposed in paragraph 1. The Member States shall, however, ensure that information received under paragraph 2 may not be disclosed in the circumstances referred to in this paragraph without the express consent of the competent authorities which disclosed it.

Article 31

Duty of persons responsible for the legal control of annual and consolidated accounts

1. Member States shall provide at least that:

(a) any person authorised within the meaning of Council Directive 84/253/EEC[14], performing in a credit institution the task described in Article 51 of Council Directive 78/660/EEC[15], or Article 37 of Council Directive 83/349/EEC, or Article 31 of Directive 85/611/EEC[16], or any other statutory task, shall have a duty to report promptly to the competent authorities any fact or decision concerning that institution of which he has become aware while carrying out that task which is liable to:

– constitute a material breach of the laws, regulations or administrative provisions which lay down the conditions governing authorisation or which specifically govern pursuit of the activities of credit institutions, or

– affect the continuous functioning of the credit institution, or

– lead to refusal to certify the accounts or to the expression of reservations;

14 Eighth Council Directive (84/253/EEC) of 10 April 1984 based on Article 44(2)(g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents (OJ L 126, 12.5.1984, p. 20).

15 Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 44(2)(g) of the Treaty on the annual accounts of certain types of companies (OJ L 222, 14.8.1978, p. 11). Directive as last amended by Directive 1999/60/EC (OJ L 62, 26.6.1999, p. 65).

16 Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) (OJ L 375, 31.12.1985, p. 3). Directive as last amended by Directive 95/26/EC (OJ L 168, 18.7.1995, p. 7).

(b) that person shall likewise have a duty to report any fact and decisions of which he becomes aware in the course of carrying out a task as described in (a) in an undertaking having close links resulting from a control relationship with the credit institution within which he is carrying out the abovementioned task.

2. The disclosure in good faith to the competent authorities, by persons authorised within the meaning of Directive 84/253/EEC, of any fact or decision referred to in paragraph 1 shall not constitute a breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision and shall not involve such persons in liability of any kind.

Article 32

Power of sanction of the competent authorities

Without prejudice to the procedures for the withdrawal of authorisations and the provisions of criminal law, the Member States shall provide that their respective competent authorities may, as against credit institutions or those who effectively control the business of credit institutions which breach laws, regulations or administrative provisions concerning the supervision or pursuit of their activities, adopt or impose in respect of them penalties or measures aimed specifically at ending observed breaches or the causes of such breaches.

Article 33

Right to apply to the courts

Member States shall ensure that decisions taken in respect of a credit institution in pursuance of laws, regulations and administrative provisions adopted in accordance with this Directive may be subject to the right to apply to the courts. The same shall apply where no decision is taken within six months of its submission in respect of an application for authorisation which contains all the information required under the provisions in force.

CHAPTER 2

TECHNICAL INSTRUMENTS OF PRUDENTIAL SUPERVISION

SECTION 1

OWN FUNDS

Article 34

General principles

1. Wherever a Member State lays down by law, regulation or administrative action a provision in implementation of Community legislation concerning the prudential supervision of an operative credit institution which uses the term or refers to the concept of own funds, it shall bring this term or concept into line with the definition given in paragraphs 2, 3 and 4 and Articles 35 to 38.

2. Subject to the limits imposed in Article 38, the unconsolidated own funds of credit institutions shall consist of the following items:

(1) capital within the meaning of Article 22 of Directive 86/635/EEC, in so far as it has been paid up, plus share premium accounts but excluding cumulative preferential shares;

(2) reserves within the meaning of Article 23 of Directive 86/635/EEC and profits and losses brought forward as a result of the application of the final profit or loss. The Member States may permit inclusion of interim profits before a formal decision has been taken only if these profits have been

verified by persons responsible for the auditing of the accounts and if it is proved to the satisfaction of the competent authorities that the amount thereof has been evaluated in accordance with the principles set out in Directive 86/635/EEC and is net of any foreseeable charge or dividend;

(3) funds for general banking risks within the meaning of Article 38 of Directive 86/635/EEC;

(4) revaluation reserves within the meaning of Article 33 of Directive 78/660/EEC;

(5) value adjustments within the meaning of Article 37(2) of Directive 86/635/EEC;

(6) other items within the meaning of Article 35;

(7) the commitments of the members of credit institutions set up as cooperative societies and the joint and several commitments of the borrowers of certain institutions organised as funds, as referred to in Article 36(1);

(8) fixed-term cumulative preferential shares and subordinated loan capital as referred to in Article 36(3).

The following items shall be deducted in accordance with Article 38:

(9) own shares at book value held by a credit institution;

(10) intangible assets within the meaning of Article 4(9) ("Assets") of Directive 86/635/EEC;

(11) material losses of the current financial year;

(12) holdings in other credit and financial institutions amounting to more than 10% of their capital, subordinated claims and the instruments referred to in Article 35 which a credit institution holds in respect of credit and financial institutions in which it has holdings exceeding 10% of the capital in each case.

Where shares in another credit or financial institution are held temporarily for the purposes of a financial assistance operation designed to reorganise and save that institution, the competent authority may waive this provision;

(13) holdings in other credit and financial institutions of up to 10% of their capital, the subordinated claims and the instruments referred to in Article 35 which a credit institution holds in respect of credit and financial institutions other than those referred to in point (12) in respect of the amount of the total of such holdings, subordinated claims and instruments which exceed 10% of that credit institution's own funds calculated before the deduction of items in point (12) and in this point.

Pending subsequent coordination of the provisions on consolidation, Member States may provide that, for the calculation of unconsolidated own funds, parent companies subject to supervision on a consolidated basis need not deduct their holdings in other credit institutions or financial institutions which are included in the consolidation. This provision shall apply to all the prudential rules harmonised by Community acts.

3. The concept of own funds as defined in points (1) to (8) of paragraph 2 embodies a maximum number of items and amounts. The use of those items and the fixing of lower ceilings, and the deduction of items other than those listed in points (9) to (13) of paragraph 2 shall be left to the discretion of the Member States. Member States shall nevertheless be obliged to consider increased convergence with a view to a common definition of own funds.

To that end, the Commission shall, by 1 January 1996 at the latest, submit a report to the European Parliament and to the Council on the application of this Article and Articles 35 to 39, accompanied, where appropriate, by such proposals for amendment as it shall deem necessary. Not later than 1 January 1998, the European Parliament and the Council shall, acting in accordance with the procedure laid down in Article 251 of the Treaty and after consultation of the Economic and Social Committee, examine the definition of own funds with a view to the uniform application of the common definition.

4. The items listed in points (1) to (5) of paragraph 2 must be available to a credit institution for unrestricted and immediate use to cover risks or losses as soon as these occur. The amount must

be net of any foreseeable tax charge at the moment of its calculation or be suitably adjusted in so far as such tax charges reduce the amount up to which these items may be applied to cover risks or losses.

Article 35

Other items

1. The concept of own funds used by a Member State may include other items provided that, whatever their legal or accounting designations might be, they have the following characteristics:

(a) they are freely available to the credit institution to cover normal banking risks where revenue or capital losses have not yet been identified;

(b) their existence is disclosed in internal accounting records;

(c) their amount is determined by the management of the credit institution, verified by independent auditors, made known to the competent authorities and placed under the supervision of the latter.

2. Securities of indeterminate duration and other instruments that fulfil the following conditions may also be accepted as other items:

(a) they may not be reimbursed on the bearer's initiative or without the prior agreement of the competent authority;

(b) the debt agreement must provide for the credit institution to have the option of deferring the payment of interest on the debt;

(c) the lender's claims on the credit institution must be wholly subordinated to those of all non-subordinated creditors;

(d) the documents governing the issue of the securities must provide for debt and unpaid interest to be such as to absorb losses, whilst leaving the credit institution in a position to continue trading;

(e) only fully paid-up amounts shall be taken into account.

To these may be added cumulative preferential shares other than those referred to in point 8 of Article 34(2).

Article 36

Other provisions concerning own funds

1. The commitments of the members of credit institutions set up as cooperative societies referred to in point 7 of Article 34(2), shall comprise those societies' uncalled capital; together with the legal commitments of the members of those cooperative societies to make additional non-refundable payments should the credit institution incur a loss, in which case it must be possible to demand those payments without delay.

The joint and several commitments of borrowers in the case of credit institutions organised as funds shall be treated in the same way as the preceding items.

All such items may be included in own funds in so far as they are counted as the own funds of institutions of this category under national law.

2. Member States shall not include in the own funds of public credit institutions guarantees which they or their local authorities extend to such entities.

3. Member States or the competent authorities may include fixed-term cumulative preferential shares referred to in point (8) of Article 34(2) and subordinated loan capital referred to in that provision in own funds, if binding agreements exist under which, in the event of the bankruptcy or liquidation of the credit institution, they rank after the claims of all other creditors and are not to be repaid until all other debts outstanding at the time have been settled.

Subordinated loan capital must also fulfil the following criteria:

(a) only fully paid-up funds may be taken into account;

(b) the loans involved must have an original maturity of at least five years, after which they may be repaid; if the maturity of the debt is not fixed, they shall be repayable only subject to five years' notice unless the loans are no longer considered as own funds or unless the prior consent of the competent authorities is specifically required for early repayment. The competent authorities may grant permission for the early repayment of such loans provided the request is made at the initiative of the issuer and the solvency of the credit institution in question is not affected;

(c) the extent to which they may rank as own funds must be gradually reduced during at least the last five years before the repayment date;

(d) the loan agreement must not include any clause providing that in specified circumstances, other than the winding-up of the credit institution, the debt will become repayable before the agreed repayment date.

Article 37

Calculation of own funds on a consolidated basis

1. Where the calculation is to be made on a consolidated basis, the consolidated amounts relating to the items listed under Article 34(2) shall be used in accordance with the rules laid down in Articles 52 to 56. Moreover, the following may, when they are credit ("negative") items, be regarded as consolidated reserves for the calculation of own funds:

- any minority interests within the meaning of Article 21 of Directive 83/349/EEC, where the global integration method is used,
- the first consolidation difference within the meaning of Articles 19, 30 and 31 of Directive 83/349/EEC,
- the translation differences included in consolidated reserves in accordance with Article 39(6) of Directive 86/635/EEC,
- any difference resulting from the inclusion of certain participating interests in accordance with the method prescribed in Article 33 of Directive 83/349/EEC.

2. Where the above are debit ("positive") items, they must be deducted in the calculation of consolidated own funds.

Article 38

Deductions and limits

1. The items referred to in points (4) to (8) of Article 34(2), shall be subject to the following limits:

(a) the total of the items in points (4) to (8) may not exceed a maximum of 100% of the items in points (1) plus (2) and (3) minus (9), (10) and (11);

(b) the total of the items in points (7) and (8) may not exceed a maximum of 50% of the items in points (1) plus (2) and (3) minus (9), (10) and (11);

(c) the total of the items in points (12) and (13) shall be deducted from the total of the items.

2. The competent authorities may authorise credit institutions to exceed the limit laid down in paragraph 1 in temporary and exceptional circumstances.

Article 39

Provision of proof to the competent authorities

Compliance with the conditions laid down in Article 34(2), (3) and (4) and Articles 35 to 38 must be proved to the satisfaction of the competent authorities.

SECTION 2

SOLVENCY RATIO

Article 40

General principles

1. The solvency ratio expresses own funds, as defined in Article 41, as a proportion of total assets and off-balance-sheet items, risk-adjusted in accordance with Article 42.

2. The solvency ratios of credit institutions which are neither parent undertakings as defined in Article 1 of Directive 83/349/EEC, nor subsidiaries of such undertakings shall be calculated on an individual basis.

3. The solvency ratios of credit institutions which are parent undertakings shall be calculated on a consolidated basis in accordance with the methods laid down in this Directive and in Directive 86/635/EEC.

4. The competent authorities responsible for authorising and supervising a parent undertaking which is a credit institution may also require the calculation of a subconsolidated or unconsolidated ratio in respect of that parent undertaking and of any of its subsidiaries which are subject to authorisation and supervision by them. Where such monitoring of the satisfactory allocation of capital within a banking group is not carried out, other measures must be taken to attain that end.

5. Without prejudice to credit institutions' compliance with the requirements of paragraphs 2, 3 and 4, and of Article 52(8) and (9), the competent authorities shall ensure that ratios are calculated not less than twice each year, either by credit institutions themselves, which shall communicate the results and any component data required to the competent authorities, or by the competent authorities, using data supplied by the credit institutions.

6. The valuation of assets and off-balance-sheet items shall be effected in accordance with Directive 86/635/EEC.

Article 41

The numerator: own funds

Own funds as defined in this Directive shall form the numerator of the solvency ratio.

Article 42

The denominator: risk-adjusted assets and off-balance-sheet items

1. Degrees of credit risk, expressed as percentage weightings, shall be assigned to asset items in accordance with Articles 43 and 44, and exceptionally Articles 45, 62 and 63. The balance-sheet value of each asset shall then be multiplied by the relevant weighting to produce a risk-adjusted value.

2. In the case of the off-balance-sheet items listed in Annex II, a two-stage calculation as prescribed in Article 43(2) shall be used.

3. In the case of the off-balance-sheet items referred to in Article 43(3), the potential costs of replacing contracts in the event of counterparty default shall be calculated by means of one of the two methods set out in Annex III. Those costs shall be multiplied by the relevant counterparty

weightings in Article 43(1), except the 100% weightings as provided for there shall be replaced by 50% weightings to produce risk-adjusted values.

4. The total of the risk-adjusted values of the assets and off-balance-sheet items mentioned in paragraphs 2 and 3 shall be the denominator of the solvency ratio.

Article 43

Risk weightings

1. The following weightings shall be applied to the various categories of asset items, although the competent authorities may fix higher weightings as they see fit:

(a) Zero weighting

(1) cash in hand and equivalent items;

(2) asset items constituting claims on Zone A central governments and central banks;

(3) asset items constituting claims on the European Communities;

(4) asset items constituting claims carrying the explicit guarantees of Zone A central governments and central banks or of the European Communities;

(5) asset items constituting claims on Zone B central governments and central banks denominated and funded in the national currencies of the borrowers;

(6) asset items constituting claims carrying the explicit guarantees of Zone B central governments and central banks denominated and funded in the national currency common to the guarantor and the borrower;

(7) asset items secured to the satisfaction of the competent authorities, by collateral in the form of Zone A central government or central bank securities or securities issued by the European Communities or by cash deposits placed with the lending institution or by certificates of deposit or similar instruments issued by and lodged with the latter;

(b) 20% weighting

(1) asset items constituting claims on the EIB;

(2) asset items constituting claims on multilateral development banks;

(3) asset items constituting claims carrying the explicit guarantee of the EIB;

(4) asset items constituting claims carrying the explicit guarantees of multilateral development banks;

(5) asset items constituting claims on Zone A regional governments or local authorities, subject to Article 44;

(6) asset items constituting claims carrying the explicit guarantees of Zone A regional governments or local authorities, subject to Article 44;

(7) asset items constituting claims on Zone A credit institutions but not constituting such institutions' own funds;

(8) asset items constituting claims with a maturity of one year or less, on Zone B credit institutions, other than securities issued by such institutions which are recognised as components of their own funds;

(9) asset items carrying the explicit guarantees of Zone A credit institutions;

(10) asset items constituting claims with a maturity of one year or less carrying the explicit guarantees of Zone B credit institutions;

(11) asset items secured, to the satisfaction of the competent authorities, by collateral in the form of securities issued by the EIB or by multilateral development banks;

(12) cash items in the process of collection;

(c) 50% weighting

(1) loans fully and completely secured, to the satisfaction of the competent authorities, by mortgages on residential property which is or will be occupied or let by the borrower, and loans fully and completely secured, to the satisfaction of the competent authorities, by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, in respect of residential property which is or will be occupied or let by the borrower;

"mortgage-backed securities" which may be treated as loans referred to in the first subparagraph or in Article 62(1), if the competent authorities consider, having regard to the legal framework in force in each Member State, that they are equivalent in the light of the credit risk. Without prejudice to the types of securities which may be included in and are capable of fulfilling the conditions in this point 1, "mortgage-backed securities" may include instruments within the meaning of Section B(1)(a) and (b) of the Annex to Council Directive 93/22/EEC[17]. The competent authorities must in particular be satisfied that:

(i) such securities are fully and directly backed by a pool of mortgages which are of the same nature as those defined in the first subparagraph or in Article 62(1) and are fully performing when the mortgage-backed securities are created;

(ii) an acceptable high-priority charge on the underlying mortgage-asset items is held either directly by investors in mortgage-backed securities or on their behalf by a trustee or mandated representative in the same proportion to the securities which they hold;

(2) prepayments and accrued income: these assets shall be subject to the weighting corresponding to the counterparty where a credit institution is able to determine it in accordance with Directive 86/635/EEC. Otherwise, where it is unable to determine the counterparty, it shall apply a flat-rate weighting of 50%;

(d) 100 % weighting

(1) asset items constituting claims on Zone B central governments and central banks except where denominated and funded in the national currency of the borrower;

(2) asset items constituting claims on Zone B regional governments or local authorities;

(3) asset items constituting claims with a maturity of more than one year on Zone B credit institutions;

(4) asset items constituting claims on the Zone A and Zone B non-bank sectors;

(5) tangible "Assets" within the meaning of Article 4(10) of Directive 86/635/EEC;

(6) holdings of shares, participation and other components of the own funds of other credit institutions which are not deducted from the own funds of the lending institutions;

(7) all other assets except where deducted from own funds.

2. The following treatment shall apply to off-balance-sheet items other than those covered in paragraph 3. They shall first be grouped according to the risk groupings set out in Annex II. The full value of the full-risk items shall be taken into account, 50% of the value of the medium-risk items and 20% of the medium/low-risk items, while the value of low-risk items shall be set at zero. The second stage shall be to multiply the off-balance-sheet values, adjusted as described above, by the weightings attributable to the relevant counterparties in accordance with the treatment of asset

17 Council Directive 93/22/EEC of 10 May 1993 on investment services in the securities field (OJ L 141, 11.6.1993, p. 27). Directive as last amended by Directive 97/9/EC (OJ L 84, 26.3.1997, p. 22).

items prescribed in paragraph 1 and Article 44. In the case of asset sale and repurchase agreements and outright forward purchases, the weightings shall be those attaching to the assets in question and not to the counterparties to the transactions. The portion of unpaid capital subscribed to the European Investment Fund may be weighted at 20%

3. The methods set out in Annex III shall be applied to the off-balance-sheet items listed in Annex IV except for:

- contracts traded on recognised exchanges,
- foreign-exchange contracts (except contracts concerning gold) with an original maturity of 14 calendar days or less.

Until 31 December 2006, the competent authorities of Member States may exempt from the application of the methods set out in Annex III over-the-counter (OTC) contracts cleared by a clearing house where the latter acts as the legal counterparty and all participants fully collateralise on a daily basis the exposure they present to the clearing house, thereby providing a protection covering both the current exposure and the potential future exposure. The competent authorities must be satisfied that the posted collateral gives the same level of protection as collateral which complies with paragraph 1(a)(7) and that the risk of a build-up of the clearing house's exposures beyond the market value of posted collateral is eliminated. Member States shall inform the Commission of the use they make of this option.

4. Where off-balance-sheet items carry explicit guarantees, they shall be weighted as if they had been incurred on behalf of the guarantor rather than the counterparty. Where the potential exposure arising from off-balance-sheet transactions is fully and completely secured, to the satisfaction of the competent authorities, by any of the asset items recognised as collateral in paragraph 1(a)(7) and (b)(11), weightings of 0% or 20% shall apply depending on the collateral in question.

The Member States may apply a 50% weighting to off-balance-sheet items which are sureties or guarantees having the character of credit substitutes and which are fully guaranteed, to the satisfaction of the competent authorities, by mortgages meeting the conditions set out in paragraph 1(c)(1), subject to the guarantor having a direct right to such collateral.

5. Where asset and off-balance-sheet items are given a lower weighting because of the existence of explicit guarantees or collateral acceptable to the competent authorities, the lower weighting shall apply only to that part which is guaranteed or which is fully covered by the collateral.

Article 44

Weighting of claims for regional governments or local authorities of the Member States

1. Notwithstanding the requirements of Article 43(1)(b), the Member States may fix a weighting of 0% for their own regional governments and local authorities if there is no difference in risk between claims on the latter and claims on their central governments because of the revenue-raising powers of the regional governments and local authorities and the existence of specific institutional arrangements the effect of which is to reduce the chances of default by the latter. A zero-weighting fixed in accordance with these criteria shall apply to claims on and off-balance-sheet items incurred on behalf of the regional governments and local authorities in question and claims on others and off-balance-sheet items incurred on behalf of others and guaranteed by those regional governments and local authorities or secured, to the satisfaction of the competent authorities concerned, by collateral in the form of securities issued by those regional governments or local authorities.

2. The Member States shall notify the Commission if they believe a zero-weighting to be justified according to the criteria laid down in paragraph 1. The Commission shall circulate that information. Other Member States may offer the credit institutions under the supervision of their competent authorities the possibility of applying a zero-weighting where they undertake business with the regional governments or local authorities in question or where they hold claims guaranteed by the latter, including collateral in the form of securities.

Article 45

Other weighting

1. Without prejudice to Article 44(1) the Member States may apply a weighting of 20% to asset items which are secured, to the satisfaction of the competent authorities concerned, by collateral in the form of securities issued by Zone A regional governments or local authorities, by deposits placed with Zone A credit institutions other than the lending institution, or by certificates of deposit or similar instruments issued by such credit institutions.

2. The Member States may apply a weighting of 10% to claims on institutions specialising in the inter-bank and public-debt markets in their home Member States and subject to close supervision by the competent authorities where those asset items are fully and completely secured, to the satisfaction of the competent authorities of the home Member States, by a combination of asset items mentioned in Article 43(1)(a) and (b) recognised by the latter as constituting adequate collateral.

3. The Member States shall notify the Commission of any provisions adopted pursuant to paragraphs 1 and 2 and of the grounds for such provisions. The Commission shall forward that information to the Member States. The Commission shall periodically examine the implications of those provisions in order to ensure that they do not result in any distortions of competition.

Article 46

Administrative bodies and non-commercial undertakings

For the purposes of Article 43 (1)(b), the competent authorities may include within the concept of regional governments and local authorities non-commercial administrative bodies responsible to regional governments or local authorities or authorities which, in the view of the competent authorities, exercise the same responsibilities as regional and local authorities.

The competent authorities may also include within the concept of regional governments and local authorities, churches and religious communities constituted in the form of a legal person under public law, in so far as they raise taxes in accordance with legislation conferring on them the right to do so. However, in this case the option set out in Article 44 shall not apply.

Article 47

Solvency ratio level

1. Credit institutions shall be required permanently to maintain the ratio defined in Article 40 at a level of at least 8%.

2. Notwithstanding paragraph 1, the competent authorities may prescribe higher minimum ratios as they consider appropriate.

3. If the ratio falls below 8% the competent authorities shall ensure that the credit institution in question takes appropriate measures to restore the ratio to the agreed minimum as quickly as possible.

SECTION 3

LARGE EXPOSURES

Article 48

Reporting of large exposures

1. A credit institution's exposure to a client or group of connected clients shall be considered a large exposure where its value is equal to or exceeds 10% of its own funds.

2. A credit institution shall report every large exposure within the meaning of paragraph 1 to the competent authorities. Member States shall provide that reporting is to be carried out, at their discretion, in accordance with one of the following two methods:

– reporting of all large exposures at least once a year, combined with reporting during the year of all new large exposures and any increases in existing large exposures of at least 20% with respect to the previous communication,

– reporting of all large exposures at least four times a year.

3. Exposures exempted under Article 49(7)(a), (b), (c), (d), (f), (g) and (h) need not, however, be reported as laid down in paragraph 2. The reporting frequency laid down in the second indent to paragraph 2 may be reduced to twice a year for the exposures referred to in Article 49(7)(e) and (i), and also in paragraphs 8, 9 and 10.

4. The competent authorities shall require that every credit institution have sound administrative and accounting procedures and adequate internal control mechanisms for the purpose of identifying and recording all large exposures and subsequent changes to them, as defined and required by this Directive, and for that of monitoring those exposures in the light of each credit institution's own exposure policies.

Where a credit institution invokes paragraph 3, it shall keep a record of the grounds advanced for at least one year after the event giving rise to the dispensation, so that the competent authorities may establish whether it is justified.

Article 49

Limits on large exposures

1. A credit institution may not incur an exposure to a client or group of connected clients the value of which exceed 25% of its own funds.

2. Where that client or group of connected clients is the parent undertaking or subsidiary of the credit institution and/or one or more subsidiaries of that parent undertaking, the percentage laid down in paragraph 1 shall be reduced to 20%. Member States may, however, exempt the exposures incurred to such clients from the 20% limit if they provide for specific monitoring of such exposures by other measures or procedures. They shall inform the Commission and the Banking Advisory Committee of the content of such measures or procedures.

3. A credit institution may not incur large exposures which in total exceed 800% of its own funds.

4. Member States may impose limits more stringent than those laid down in paragraphs 1, 2 and 3.

5. A credit institution shall at all times comply with the limits laid down in paragraphs 1, 2 and 3 in respect of its exposures. If in an exceptional case exposures exceed those limits, that fact must be reported without delay to the competent authorities which may, where the circumstances warrant it, allow the credit institution a limited period of time in which to comply with the limits.

6. Member States may fully or partially exempt from the application of paragraphs 1, 2 and 3 exposures incurred by a credit institution to its parent undertaking, to other subsidiaries of that parent undertaking or to its own subsidiaries, in so far as those undertakings are covered by the supervision on a consolidated basis to which the credit institution itself is subject, in accordance with this Directive or with equivalent standards in force in a third country.

7. Member States may fully or partially exempt the following exposures from the application of paragraphs 1, 2 and 3:

(a) asset items constituting claims on Zone A central governments or central banks;

(b) asset items constituting claims on the European Communities;

(c) asset items constituting claims carrying the explicit guarantees of Zone A central governments or central banks or of the European Communities;

(d) other exposures attributable to, or guaranteed by, Zone A central governments or central banks or the European Communities;

(e) asset items constituting claims on and other exposures to Zone B central governments or central banks which are denominated and, where applicable, funded in the national currencies of the borrowers;

(f) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of Zone A central government or central bank securities, or securities issued by the European Communities or by Member State regional or local authorities for which Article 44 lays down a zero weighting for solvency purposes;

(g) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of cash deposits placed with the lending institution or with a credit institution which is the parent undertaking or a subsidiary of the lending institution;

(h) asset items and other exposures secured, to the satisfaction of the competent authorities, by collateral in the form of certificates of deposit issued by the lending institution or by a credit institution which is the parent undertaking or a subsidiary of the lending institution and lodged with either of them;

(i) asset items constituting claims on and other exposures to credit institutions, with a maturity of one year or less, but not constituting such institutions' own funds;

(j) asset items constituting claims on and other exposures to those institutions which are not credit institutions but which fulfil the conditions referred to in Article 45(2), with a maturity of one year or less, and secured in accordance with the same paragraph;

(k) bills of trade and other similar bills, with a maturity of one year or less, bearing the signatures of other credit institutions;

(l) debt securities as defined in Article 22(4) of Directive 85/611/EEC;

(m) pending subsequent coordination, holdings in the insurance companies referred to in Article 51(3) up to 40% of the own funds of the credit institution acquiring such a holding;

(n) asset items constituting claims on regional or central credit institutions with which the lending institution is associated in a network in accordance with legal or statutory provisions and which are responsible, under those provisions, for cash-clearing operations within the network;

(o) exposures secured, to the satisfaction of the competent authorities, by collateral in the form of securities other than those referred to in (f) provided that those securities are not issued by the credit institution itself, its parent company or one of their subsidiaries, or by the client or group of connected clients in question. The securities used as collateral must be valued at market price, have a value that exceeds the exposures guaranteed and be either traded on a stock exchange or effectively negotiable and regularly quoted on a market operated under the auspices of recognised professional operators and allowing, to the satisfaction of the competent authorities of the Member State of origin of the credit institution, for the establishment of an objective price such that the excess value of the securities may be verified at any time. The excess value required shall be 100% it shall, however, be 150% in the case of shares and 50% in the case of debt securities issued by credit institutions, Member State regional or local authorities other than those referred to in Article 44, and in the case of debt securities issued by the EIB and multilateral development banks. Securities used as collateral may not constitute credit institutions' own funds;

(p) loans secured, to the satisfaction of the competent authorities, by mortgages on residential property or by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation and leasing transactions under which the lessor retains full ownership of the residential property leased for as long as the lessee has not exercised his option to purchase, in all cases up to 50% of the value of the residential

property concerned. The value of the property shall be calculated, to the satisfaction of the competent authorities, on the basis of strict valuation standards laid down by law, regulation or administrative provisions. Valuation shall be carried out at least once a year. For the purposes of this point residential property shall mean a residence to be occupied or let by the borrower;

(q) 50% of the medium/low-risk off-balance-sheet items referred to in Annex II;

(r) subject to the competent authorities' agreement, guarantees other than loan guarantees which have a legal or regulatory basis and are given for their members by mutual guarantee schemes possessing the status of credit institutions, subject to a weighting of 20% of their amount.

Member States shall inform the Commission of the use they make of this option in order to ensure that it does not result in distortions of competition;

(s) the low-risk off-balance-sheet items referred to in Annex II, to the extent that an agreement has been concluded with the client or group of connected clients under which the exposure may be incurred only if it has been ascertained that it will not cause the limits applicable under paragraphs 1, 2 and 3 to be exceeded.

8. For the purposes of paragraphs 1, 2 and 3, Member States may apply a weighting of 20% to asset items constituting claims on Member State regional and local authorities and to other exposures to or guaranteed by such authorities; subject to the conditions laid down in Article 44, however, Member States may reduce that rate to 0%.

9. For the purposes of paragraphs 1, 2 and 3, Member States may apply a weighting of 20 % to asset items constituting claims on and other exposures to credit institutions with a maturity of more than one but not more than three years and a weighting of 50% to asset items constituting claims on credit institutions with a maturity of more than three years, provided that the latter are represented by debt instruments that were issued by a credit institution and that those debt instruments are, in the opinion of the competent authorities, effectively negotiable on a market made up of professional operators and are subject to daily quotation on that market, or the issue of which was authorised by the competent authorities of the Member State of origin of the issuing credit institutions. In no case may any of these items constitute own funds.

10. By way of derogation from paragraphs 7(i) and 9, Member States may apply a weighting of 20% to asset items constituting claims on and other exposures to credit institutions, regardless of their maturity.

11. Where an exposure to a client is guaranteed by a third party, or by collateral in the form of securities issued by a third party under the conditions laid down in paragraph 7(o), Member States may:

- treat the exposure as having been incurred to the third party rather than to the client, if the exposure is directly and unconditionally guaranteed by that third party, to the satisfaction of the competent authorities,
- treat the exposure as having been incurred to the third party rather than to the client, if the exposure defined in paragraph 7(o) is guaranteed by collateral under the conditions there laid down.

12. By 1 January 1999 at the latest, the Council shall, on the basis of a report from the Commission, examine the treatment of interbank exposures provided for in paragraphs 7(i), 9 and 10. The Council shall decide on any changes to be made on a proposal from the Commission.

Article 50

Supervision on a consolidated or unconsolidated basis of large exposures

1. If the credit institution is neither a parent undertaking nor a subsidiary, compliance with the obligations imposed in Articles 48 and 49 or in any other Community provision applicable to this area shall be monitored on an unconsolidated basis.

2. In the other cases, compliance with the obligations imposed in Articles 48 and 49 or in any other Community provision applicable to this area shall be monitored on a consolidated basis in accordance with Articles 52 to 56.

3. Member States may waive monitoring on an individual or subconsolidated basis of compliance with the obligations imposed in Articles 48 and 49 or in any other Community provision applicable to this area by a credit institution which, as a parent undertaking, is subject to monitoring on a consolidated basis and by any subsidiary of such a credit institution which is subject to their authorisation and supervision and is covered by monitoring on a consolidated basis.

Member States also waive such monitoring where the parent undertaking is a financial holding company established in the same Member State as the credit institution, provided that company is subject to the same monitoring as credit institutions.

In the cases referred to in the first and second subparagraphs measures must be taken to ensure the satisfactory allocation of risks within the group.

SECTION 4

QUALIFYING HOLDINGS OUTSIDE THE FINANCIAL SECTOR

Article 51

Limits to non-financial qualifying holdings

1. No credit institution may have a qualifying holding the amount of which exceeds 15% of its own funds in an undertaking which is neither a credit institution, nor a financial institution, nor an undertaking carrying on an activity referred to in the second subparagraph of Article 43(2)(f) of Directive 86/635/EEC.

2. The total amount of a credit institution's qualifying holdings in undertakings other than credit institutions, financial institutions or undertakings carrying on activities referred to in the second subparagraph of Article 43(2)(f) of Directive 86/635/EEC may not exceed 60% of its own funds.

3. The Member States need not apply the limits laid down in paragraphs 1 and 2 to holdings in insurance companies as defined in Directive 73/239/EEC[18], and Directive 79/267/EEC[19].

4. Shares held temporarily during a financial reconstruction or rescue operation or during the normal course of underwriting or in an institution's own name on behalf of others shall not be counted as qualifying holdings for the purpose of calculating the limits laid down in paragraphs 1 and 2. Shares which are not financial fixed assets as defined in Article 35(2) of Directive 86/635/EEC shall not be included.

5. The limits laid down in paragraphs 1 and 2 may be exceeded only in exceptional circumstances. In such cases, however, the competent authorities shall require a credit institution either to increase its own funds or to take other equivalent measures.

6. The Member States may provide that the competent authorities shall not apply the limits laid down in paragraphs 1 and 2 if they provide that 100% of the amounts by which a credit institution's qualifying holdings exceed those limits must be covered by own funds and that the latter shall not be included in the calculation of the solvency ratio. If both the limits laid down in paragraphs 1 and 2 are exceeded, the amount to be covered by own funds shall be the greater of the excess amounts.

18 First Council Directive 73/239/EEC of 24 July 1973 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct insurance other than life assurance (OJ L 228, 16.8.1973, p. 3). Directive as last amended by Directive 95/26/EC.

19 First Council Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking-up and pursuit of the business of direct life assurance (OJ L 63, 13.3.1979, p. 1). Directive as last amended by Directive 95/26/EC

CHAPTER 3

SUPERVISION ON A CONSOLIDATED BASIS

Article 52

Supervision on a consolidated basis of credit institutions

1. Every credit institution which has a credit institution or a financial institution as a subsidiary or which holds a participation in such institutions shall be subject, to the extent and in the manner prescribed in Article 54, to supervision on the basis of its consolidated financial situation. Such supervision shall be exercised at least in the areas referred to in paragraphs 5 and 6.

2. Every credit institution the parent undertaking of which is a financial holding company shall be subject, to the extent and in the manner prescribed in Article 54, to supervision on the basis of the consolidated financial situation of that financial holding company. Such supervision shall be exercised at least in the areas referred to in paragraphs 5 and 6. The consolidation of the financial situation of the financial holding company shall not in any way imply that the competent authorities are required to play a supervisory role in relation to the financial holding company standing alone.

3. The Member States or the competent authorities responsible for exercising supervision on a consolidated basis pursuant to Article 53 may decide in the cases listed below that a credit institution, financial institution or auxiliary banking services undertaking which is a subsidiary or in which a participation is held need not be included in the consolidation:

– if the undertaking that should be included is situated in a third country where there are legal impediments to the transfer of the necessary information,

– if, in the opinion of the competent authorities, the undertaking that should be included is of negligible interest only with respect to the objectives of monitoring credit institutions and in all cases if the balance-sheet total of the undertaking that should be included is less than the smaller of the following two amounts: €10 million or 1% of the balance-sheet total of the parent undertaking or the undertaking that holds the participation. If several undertakings meet the above criteria, they must nevertheless be included in the consolidation where collectively they are of non-negligible interest with respect to the aforementioned objectives, or

– if, in the opinion of the competent authorities responsible for exercising supervision on a consolidated basis, the consolidation of the financial situation of the undertaking that should be included would be inappropriate or misleading as far as the objectives of the supervision of credit institutions are concerned.

4. When the competent authorities of a Member State do not include a credit institution subsidiary in supervision on a consolidated basis under one of the cases provided for in the second and third indents of paragraph 3, the competent authorities of the Member State in which that credit institution subsidiary is situated may ask the parent undertaking for information which may facilitate their supervision of that credit institution.

5. Supervision of solvency, and of the adequacy of own funds to cover market risks and control of large exposures shall be exercised on a consolidated basis in accordance with this Article and Articles 53 to 56. Member States shall adopt any measures necessary, where appropriate, to include financial holding companies in consolidated supervision, in accordance with paragraph 2.

Compliance with the limits set in Article 51(1) and (2) shall be supervised and controlled on the basis of the consolidated or subconsolidated financial situation of the credit institution.

6. The competent authorities shall ensure that, in all the undertakings included in the scope of the supervision on a consolidated basis that is exercised over a credit institution in implementation of

paragraphs 1 and 2, there are adequate internal control mechanisms for the production of any data and information which would be relevant for the purposes of supervision on a consolidated basis.

7. Without prejudice to specific provisions contained in other directives, Member States may waive application, on an individual or subconsolidated basis, of the rules laid down in paragraph 5 to a credit institution that, as a parent undertaking, is subject to supervision on a consolidated basis, and to any subsidiary of such a credit institution which is subject to their authorisation and supervision and is included in the supervision on a consolidated basis of the credit institution which is the parent company. The same exemption option shall be allowed where the parent undertaking is a financial holding company which has its head office in the same Member State as the credit institution, provided that it is subject to the same supervision as that exercised over credit institutions, and in particular the standards laid down in paragraph 5.

In both cases set out in the first subparagraph, steps must be taken to ensure that capital is distributed adequately within the banking group.

If the competent authorities apply those rules individually to such credit institutions, they may, for the purpose of calculating own funds, make use of the provision in the last subparagraph of Article 3(2).

8. Where a credit institution the parent of which is a credit institution has been authorised and is situated in another Member State, the competent authorities which granted that authorisation shall apply the rules laid down in paragraph 5 to that institution on an individual or, when appropriate, a subconsolidated basis.

9. Notwithstanding the requirements of paragraph 8, the competent authorities responsible for authorising the subsidiary of a parent undertaking which is a credit institution may, by bilateral agreement, delegate their responsibility for supervision to the competent authorities which authorised and supervise the parent undertaking so that they assume responsibility for supervising the subsidiary in accordance with this Directive. The Commission must be kept informed of the existence and content of such agreements. It shall forward such information to the competent authorities of the other Member States and to the Banking Advisory Committee.

10. Member States shall provide that their competent authorities responsible for exercising supervision on a consolidated basis may ask the subsidiaries of a credit institution or a financial holding company which are not included within the scope of supervision on a consolidated basis for the information referred to in Article 55. In such a case, the procedures for transmitting and verifying the information laid down in that Article shall apply.

Article 53

Competent authorities responsible for exercising supervision on a consolidated basis

1. Where a parent undertaking is a credit institution, supervision on a consolidated basis shall be exercised by the competent authorities that authorised it under Article 4.

2. Where the parent of a credit institution is a financial holding company, supervision on a consolidated basis shall be exercised by the competent authorities which authorised that credit institution under Article 4.

However, where credit institutions authorised in two or more Member States have as their parent the same financial holding company, supervision on a consolidated basis shall be exercised by the competent authorities of the credit institution authorised in the Member State in which the financial holding company was set up.

If no credit institution subsidiary has been authorised in the Member State in which the financial holding company was set up, the competent authorities of the Member States concerned (including those of the Member State in which the financial holding company was set up) shall seek to reach agreement as to who amongst them will exercise supervision on a consolidated basis. In the absence of such agreement, supervision on a consolidated basis shall be exercised by the competent

authorities that authorised the credit institution with the greatest balance-sheet total; if that figure is the same, supervision on a consolidated basis shall be exercised by the competent authorities which first gave the authorisation referred to in Article 4.

3. The competent authorities concerned may by common agreement waive the rules laid down in the first and second subparagraph of paragraph 2.

4. The agreements referred to in the third subparagraph of paragraph 2 and in paragraph 3 shall provide for procedures for cooperation and for the transmission of information such that the objectives of supervision on a consolidated basis can be attained.

5. Where Member States have more than one competent authority for the prudential supervision of credit institutions and financial institutions, Member States shall take the requisite measures to organise coordination between such authorities.

Article 54

Form and extent of consolidation

1. The competent authorities responsible for exercising supervision on a consolidated basis must, for the purposes of supervision, require full consolidation of all the credit institutions and financial institutions which are subsidiaries of a parent undertaking.

However, proportional consolidation may be prescribed where, in the opinion of the competent authorities, the liability of a parent undertaking holding a share of the capital is limited to that share of the capital because of the liability of the other shareholders or members whose solvency is satisfactory. The liability of the other shareholders and members must be clearly established, if necessary by means of formal signed commitments.

2. The competent authorities responsible for carrying out supervision on a consolidated basis must, in order to do so, require the proportional consolidation of participations in credit institutions and financial institutions managed by an undertaking included in the consolidation together with one or more undertakings not included in the consolidation, where those undertakings' liability is limited to the share of the capital they hold.

3. In the case of participations or capital ties other than those referred to in paragraphs 1 and 2, the competent authorities shall determine whether and how consolidation is to be carried out. In particular, they may permit or require use of the equity method. That method shall not, however, constitute inclusion of the undertakings concerned in supervision on a consolidated basis.

4. Without prejudice to paragraphs 1, 2 and 3, the competent authorities shall determine whether and how consolidation is to be carried out in the following cases:

– where, in the opinion of the competent authorities, a credit institution exercises a significant influence over one or more credit institutions or financial institutions, but without holding a participation or other capital ties in these institutions,

– where two or more credit institutions or financial institutions are placed under single management other than pursuant to a contract or clauses of their memoranda or articles of association,

– where two or more credit institutions or financial institutions have administrative, management or supervisory bodies with the same persons constituting a majority.

In particular, the competent authorities may permit, or require use of, the method provided for in Article 12 of Directive 83/349/EEC. That method shall not, however, constitute inclusion of the undertakings concerned in consolidated supervision.

5. Where consolidated supervision is required pursuant to Article 52(1) and (2), ancillary banking services undertakings shall be included in consolidations in the cases, and in accordance with the methods laid down in paragraphs 1 to 4 of this Article.

Article 55

Information to be supplied by mixed-activity holding companies and their subsidiaries

1. Pending further coordination of consolidation methods, Member States shall provide that, where the parent undertaking of one or more credit institutions is a mixed-activity holding company, the competent authorities responsible for the authorisation and supervision of those credit institutions shall, by approaching the mixed-activity holding company and its subsidiaries either directly or via credit institution subsidiaries, require them to supply any information which would be relevant for the purpose of supervising the credit institution subsidiaries.

2. Member States shall provide that their competent authorities may carry out, or have carried out by external inspectors, on-the-spot inspections to verify information received from mixed-activity holding companies and their subsidiaries. If the mixed-activity holding company or one of its subsidiaries is an insurance undertaking, the procedure laid down in Article 56(4) may also be used. If a mixed-activity holding company or one of its subsidiaries is situated in a Member State other than that in which the credit institution subsidiary is situated, on-the-spot verification of information shall be carried out in accordance with the procedure laid down in Article 56(7).

Article 56

Measures to facilitate supervision on a consolidated basis

1. Member States shall take the necessary steps to ensure that there are no legal impediments preventing the undertakings included within the scope of supervision on a consolidated basis, mixed-activity holding companies and their subsidiaries, or subsidiaries of the kind covered in Article 52(10), from exchanging amongst themselves any information which would be relevant for the purposes of supervision in accordance with Articles 52 to 55 and this Article.

2. Where a parent undertaking and any of its subsidiaries that are credit institutions are situated in different Member States, the competent authorities of each Member State shall communicate to each other all relevant information which may allow or aid the exercise of supervision on a consolidated basis.

Where the competent authorities of the Member State in which a parent undertaking is situated do not themselves exercise supervision on a consolidated basis pursuant to Article 53, they may be invited by the competent authorities responsible for exercising such supervision to ask the parent undertaking for any information which would be relevant for the purposes of supervision on a consolidated basis and to transmit it to these authorities.

3. Member States shall authorise the exchange between their competent authorities of the information referred to in paragraph 2, on the understanding that, in the case of financial holding companies, financial institutions or ancillary banking services undertakings, the collection or possession of information shall not in any way imply that the competent authorities are required to play a supervisory role in relation to those institutions or undertakings standing alone.

Similarly, Member States shall authorise their competent authorities to exchange the information referred to in Article 55 on the understanding that the collection or possession of information does not in any way imply that the competent authorities play a supervisory role in relation to the mixed-activity holding company and those of its subsidiaries which are not credit institutions, or to subsidiaries of the kind covered in Article 52(10).

4. Where a credit institution, financial holding company or a mixed-activity holding company controls one or more subsidiaries which are insurance companies or other undertakings providing investment services which are subject to authorisation, the competent authorities and the authorities entrusted with the public task of supervising insurance undertakings or those other undertakings providing investment services shall cooperate closely. Without prejudice to their respective responsibilities, those authorities shall provide one another with any information likely to simplify their task and to allow supervision of the activity and overall financial situation of the undertakings they supervise.

5. Information received, in the framework of supervision on a consolidated basis, and in particular any exchange of information between competent authorities which is provided for in this Directive, shall be subject to the obligation of professional secrecy defined in Article 30.

6. The competent authorities responsible for supervision on a consolidated basis shall establish lists of the financial holding companies referred to in Article 52(2). Those lists shall be communicated to the competent authorities of the other Member States and to the Commission.

7. Where, in applying this Directive, the competent authorities of one Member State wish in specific cases to verify the information concerning a credit institution, a financial holding company, a financial institution, an ancillary banking services undertaking, a mixed-activity holding company, a subsidiary of the kind covered in Article 55 or a subsidiary of the kind covered in Article 52(10), situated in another Member State, they must ask the competent authorities of that other Member State to have that verification carried out. The authorities which receive such a request must, within the framework of their competence, act upon it either by carrying out the verification themselves, by allowing the authorities who made the request to carry it out, or by allowing an auditor or expert to carry it out.

8. Without prejudice to their provisions of criminal law, Member States shall ensure that penalties or measures aimed at ending observed breaches or the causes of such breaches may be imposed on financial holding companies and mixed-activity holding companies, or their effective managers, that infringe laws, regulation or administrative provisions enacted to implement Articles 52 to 55 and this Article. In certain cases, such measures may require the intervention of the courts. The competent authorities shall cooperate closely to ensure that the abovementioned penalties or measures produce the desired results, especially when the central administration or main establishment of a financial holding company or of a mixed-activity holding company is not located at its head office.

TITLE VI
BANKING ADVISORY COMMITTEE

Article 57

Composition and tasks of the Banking Advisory Committee

1. A Banking Advisory Committee of the competent authorities of the Member States shall be set up alongside the Commission.

2. The tasks of the Banking Advisory Committee shall be to assist the Commission in ensuring the proper implementation of this Directive. Further it shall carry out the other tasks prescribed by this Directive and shall assist the Commission in the preparation of new proposals to the Council concerning further coordination in the sphere of credit institutions.

3. The Banking Advisory Committee shall not concern itself with concrete problems relating to individual credit institutions.

4. The Banking Advisory Committee shall be composed of not more than three representatives from each Member State and from the Commission. These representatives may be accompanied by advisers from time to time and subject to the prior agreement of the Committee. The Committee may also invite qualified persons and experts to participate in its meetings. The secretariat shall be provided by the Commission.

5. The Banking Advisory Committee shall adopt its rules of procedure and elect a chairman from among the representatives of Member States. It shall meet at regular intervals and whenever the situation demands. The Commission may ask the Committee to hold an emergency meeting if it considers that the situation so requires.

6. The Banking Advisory Committee's discussions and the outcome thereof shall be confidential except when the Committee decides otherwise.

Article 58

Examination of the requirements for authorisation

The Banking Advisory Committee shall examine the content given by the competent authorities to requirements listed in Articles 5(1) and 6(1), any other requirements which the Member States apply and the information which must be included in the programme of operations, and shall, where appropriate, make suggestions to the Commission with a view to a more detailed coordination.

Article 59

Observation ratios

1. Pending subsequent coordination, the competent authorities shall, for the purposes of observation and, if necessary, in addition to such coefficients as may be applied by them, establish ratios between the various assets and/or liabilities of credit institutions with a view to monitoring their solvency and liquidity and the other measures which may serve to ensure that savings are protected.

To this end, the Banking Advisory Committee shall decide on the content of the various factors of the observation ratios referred to in the first subparagraph and lay down the method to be applied in calculating them.

Where appropriate, the Banking Advisory Committee shall be guided by technical consultations between the supervisory authorities of the categories of institutions concerned.

2. The observation ratios established in pursuance of paragraph 1 shall be calculated at least every six months.

3. The Banking Advisory Committee shall examine the results of analyses carried out by the supervisory authorities referred to in the third subparagraph of paragraph 1 on the basis of the calculations referred to in paragraph 2.

4. The Banking Advisory Committee may make suggestions to the Commission with a view to coordinating the coefficients applicable in the Member States.

TITLE VII
POWERS OF EXECUTION

Article 60

Technical adaptations

1. Without prejudice, regarding own funds, to the report referred to in the second subparagraph of Article 34(3), the technical adaptations in the following areas shall be adopted in accordance with the procedure laid down in paragraph 2:

- clarification of the definitions in order to take account in the application of this Directive of developments on financial markets,
- clarification of the definitions to ensure uniform application of this Directive in the Community,
- the alignment of terminology on and the framing of definitions in accordance with subsequent acts on credit institutions and related matters,
- the definition of “Zone A” in Article 1(14),
- the definition of “multilateral development banks” in Article 1(19),
- alteration of the amount of initial capital prescribed in Article 5 to take account of developments in the economic and monetary field,
- expansion of the content of the list referred to in Articles 18 and 19 and set out in Annex I or adaptation of the terminology used in that list to take account of developments on financial markets,
- the areas in which the competent authorities must exchange information as listed in Article 28,
- amendment of the definitions of the assets listed in Article 43 in order to take account of developments on financial markets,
- the list and classification of off-balance-sheet items in Annexes II and IV and their treatment in the calculation of the ratio as described in Articles 42, 43 and 44 and Annex III,
- a temporary reduction in the minimum ratio prescribed in Article 47 or the weighting prescribed in Article 43 in order to take account of specific circumstances,
- clarification of exemptions provided for in Article 49(5) to (10).

2. The Commission shall be assisted by a committee.

Where reference is made to this paragraph, Articles 5 and 7 of Decision 1999/468/EC shall apply, having regard to the provisions of Article 8 thereof.

The period laid down in Article 5(6) of Decision 1999/468/EC shall be set at three months.

The Committee shall adopt its rules of procedure.

TITLE VIII
TRANSITIONAL AND FINAL PROVISIONS

CHAPTER I

TRANSITIONAL PROVISIONS

Article 61

Transitional provisions regarding Article 36

Denmark may allow its mortgage credit institutions organised as cooperative societies or funds before 1 January 1990 and converted into public limited liability companies to continue to include joint and several commitments of members, or of borrowers as referred to in Article 36(1) claims on whom are treated in the same way as such joint and several commitments, in their own funds, subject to the following limits:

(a) the basis for calculation of the part of joint and several commitments of borrowers shall be the total of the items referred to in Article 34(2)(1) and (2), minus those referred to in Article 34(2)(9), (10) and (11);

(b) the basis for calculation on 1 January 1991 or, if converted at a later date, on the date on conversion, shall be the maximum basis for calculation. The basis for calculation may never exceed the maximum basis for calculation;

(c) the maximum basis for calculation shall, from 1 January 1997, be reduced by half of the proceeds from any issue of new capital, as defined in Article 34(2)(1), made after that date; and

(d) the maximum amount of joint and several commitments of borrowers to be included as own funds must never exceed:

50% in 1991 and 1992,

45% in 1993 and 1994,

40% in 1995 and 1996,

35% in 1997,

30% in 1998,

20% in 1999,

10% in 2000, and

0% after 1 January 2001, of the basis for calculation.

Article 62

Transitional provisions regarding Article 43

1. Until 31 December 2006, the competent authorities of the Member States may authorise their credit institutions to apply a 50% risk weighting to loans fully and completely secured to their satisfaction by mortgages on offices or on multi-purpose commercial premises situated within the territory of those Member States that allow the 50% risk weighting, subject to the following conditions:

(i) the 50% risk weighting applies to the part of the loan that does not exceed a limit calculated according to either (a) or (b):

(a) 50% of the market value of the property in question.

The market value of the property must be calculated by two independent valuers making independent assessments at the time the loan is made. The loan must be based on the lower of the two valuations.

The property shall be revalued at least once a year by one valuer. For loans not exceeding €1 million and 5% of the own funds of the credit institution, the property shall be revalued at least every three years by one valuer;

(b) 50% of the market value of the property or 60% of the mortgage lending value, whichever is lower, in those Member States that have laid down rigorous criteria for the assessment of the mortgage lending value in statutory or regulatory provisions.

The mortgage lending value shall means the value of the property as determined by a valuer making a prudent assessment of the future marketability of the property by taking into account long-term sustainable aspects of the property, the normal and local market conditions, the current use and alternative appropriate uses of the property. Speculative elements shall not be taken into account in the assessment of the mortgage lending value. The mortgage lending value shall be documented in a transparent and clear manner.

At least every three years or if the market falls by more than 10% the mortgage lending value and in particular the underlying assumptions concerning the development of the relevant market, shall be reassessed.

In both (a) and (b) "market value" shall mean the price at which the property could be sold under private contract between a willing seller and an arm's-length buyer on the date of valuation, it being assumed that the property is publicly exposed to the market, that market conditions permit orderly disposal and that a normal period, having regard to the nature of the property, is available for the negotiation of the sale;

(ii) the 100% risk weighting applies to the part of the loan that exceeds the limits set out in (i);

(iii) the property must be either used or let by the owner.

The first subparagraph shall not prevent the competent authorities of a Member State, which applies a higher risk weighting in its territory, from allowing, under the conditions defined above, the 50 % risk weighting to apply for this type of lending in the territories of those Member States that allow the 50% risk weighting.

The competent authorities of the Member States may allow their credit institutions to apply a 50 % risk weighting to the loans outstanding on 21 July 2000 provided that the conditions listed in this paragraph are fulfilled. In this case the property shall be valued according to the assessment criteria laid down above not later than 21 July 2003.

For loans granted before 31 December 2006, the 50% risk weighting remains applicable until their maturity, if the credit institution is bound to observe the contractual terms.

Until 31 December 2006, the competent authorities of the Member State may also authorise their credit institutions to apply a 50% risk weighting to the part of the loans fully and completely secured to their satisfaction by shares in Finnish housing companies operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation, provided that the conditions laid down in this paragraph are fulfilled.

Member States shall inform the Commission of the use they make of this paragraph.

2. Member States may apply a 50% risk weighting to property leasing transactions concluded before 31 December 2006 and concerning assets for business use situated in the country of the head office and governed by statutory provisions whereby the lessor retains full ownership of the rented asset until the tenant exercises his option to purchase. Member States shall inform the Commission of the use they make of this paragraph.

3. Article 43(3) shall not affect the competent authorities' recognition of bilateral contracts for novation concluded concerning:

– Belgium, before 23 April 1996,

– Denmark, before 1 June 1996,

– Germany, before 30 October 1996,

– Greece, before 27 March 1997,

– Spain, before 7 January 1997,

– France, before 30 May 1996,

– Ireland, before 27 June 1996,

– Italy, before 30 July 1996,

– Luxembourg, before 29 May 1996,

– The Netherlands, before 1 July 1996,

– Austria, before 30 December 1996,

– Portugal, before 15 January 1997,

– Finland, before 21 August 1996,

– Sweden, before 1 June 1996, and

– United Kingdom, before 30 April 1996.

Article 63

Transitional provisions regarding Article 47

1. A credit institution, the minimum ratio of which has not reached the 8% prescribed in Article 47(1), by 1 January 1991, must gradually approach that level by successive stages. It may not allow the ratio to fall below the level reached before that objective has been attained. Any fluctuation should be temporary and the competent authorities should be apprised of the reasons for it.

2. For not more than five years after 1 January 1993, the Member States may fix a weighting of 10% for the bonds defined in Article 22(4) of Directive 85/611/EEC and maintain if for credit institutions when and if they consider it necessary, to avoid grave disturbances in the operation of their markets. Such exceptions shall be reported to the Commission.

3. For not more than seven years after 1 January 1993, Article 47(1) shall not apply to the Agricultural Bank of Greece. However, the latter must approach the level prescribed in Article 47(1) by successive stages according to the method described in paragraph 1 of this Article.

Article 64

Transitional provisions regarding Article 49

1. If, on 5 February 1993, a credit institution had already incurred an exposure or exposures exceeding either the large exposure limit or the aggregate large exposure limit laid down in Article 49, the competent authorities shall require the credit institution concerned to take steps to have that exposure or those exposures brought within the limits laid down in Article 49.

2. The process of having such an exposure or exposures brought within authorised limits shall be devised, adopted, implemented and completed within the period which the competent authorities consider consistent with the principle of sound administration and fair competition. The competent authorities shall inform the Commission and the Banking Advisory Committee of the schedule for the general process adopted.

3. A credit institution may not take any measure which would cause the exposures referred to in paragraph 1 to exceed their level on 5 February 1993.

4. The period applicable under paragraph 2 shall expire no later than 31 December 2001. Exposures with a longer maturity, for which the lending institution is bound to observe the contractual terms, may be continued until their maturity.

5. Until 31 December 1998, Member States may increase the limit laid down in Article 49(1) to 40% and the limit laid down in Article 49(2) to 30%. In such cases and subject to paragraphs 1 to 4, the time limit for bringing the exposures existing at the end of this period within the limit laid down in Article 49 shall expire on 31 December 2001.

6. In the case of credit institutions the own funds of which do not exceed €7 million and only in the case of such institutions, Member States may extend the time limits laid down in paragraph 5 by five years. Member States that avail themselves of the option provided for in this paragraph shall take steps to prevent distortions of competition and shall inform the Commission and the Banking Advisory Committee thereof.

7. In the cases referred to in paragraphs 5 and 6, an exposure may be considered a large exposure if its value is equal to or exceeds 15% of own funds.

8. Until 31 December 2001 Member States may substitute a frequency of at least twice a year for the frequency of notification of large exposures referred to in the second indent of Article 48(2).

9. Member States may fully or partially exempt from the application of Article 49(1), (2) and (3) exposures incurred by a credit institution consisting of mortgage loans as defined in Article 62(1) concluded before 1 January 2002 as well as property leasing transactions as defined in Article 62(2) concluded before 1 January 2002, in both cases up to 50% of the value of the property concerned.

The same treatment applies to loans secured, to the satisfaction of the competent authorities, by shares in Finnish residential housing companies, operating in accordance with the Finnish Housing Company Act of 1991 or subsequent equivalent legislation which are similar to the mortgage loans referred to in the first subparagraph.

Article 65

Transitional provisions regarding Article 51

Credit institutions which, on 1 January 1993, exceeded the limits laid down in Articles 51(1) and (2) shall have until 1 January 2003 to comply with them.

CHAPTER 2

FINAL PROVISIONS

Article 66

Commission information

Member States shall communicate to the Commission the texts of the main laws, regulations and administrative provisions which they adopt in the field covered by this Directive.

Article 67

Repealed Directives

1. Directives 73/183/EEC, 77/780/EEC, 89/299/EEC, 89/646/EEC, 89/647/EEC, 92/30/EEC and 92/121/EEC, as amended by the Directives set out in Annex V, Part A, are hereby repealed without prejudice to the obligations of the Member States concerning the deadlines for transposition of the said Directives listed in Annex V, Part B.

2. References to the repealed Directives shall be construed as references to this Directive and should be read in accordance with the correlation table in Annex VI.

Article 68

Implementation

This Directive shall enter into force on the 20th day following its publication in the Official Journal of the European Communities.

Article 69

Addressees

This Directive is addressed to the Member States.

Done at Brussels, 20 March 2000.

For the European Parliament	For the Council
The President	The President
N. Fontaine	J. Gama

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ANNEX I

LIST OF ACTIVITIES SUBJECT TO MUTUAL RECOGNITION

1. Acceptance of deposits and other repayable funds

2. Lending

3. Financial leasing

4. Money transmission services

5. Issuing and administering means of payment (e.g. credit cards, travellers' cheques and bankers' drafts)

6. Guarantees and commitments

7. Trading for own account or for account of customers in:

(a) money market instruments (cheques, bills, certificates of deposit, etc.)

(b) foreign exchange;

(c) financial futures and options;

(d) exchange and interest-rate instruments;

(e) transferable securities

8. Participation in securities issues and the provision of services related to such issues

9. Advice to undertakings on capital structure, industrial strategy and related questions and advice as well as services relating to mergers and the purchase of undertakings

10. Money broking

11. Portfolio management and advice

12. Safekeeping and administration of securities

13. Credit reference services

14. Safe custody services

1 Including, inter alia: consumer credit, mortgage credit, factoring, with or without recourse, financing of commercial transactions (including forfeiting).

ANNEX II

CLASSIFICATION OF OFF-BALANCE-SHEET ITEMS

Full risk

- Guarantees having the character of credit substitutes,
- Acceptances,
- Endorsements on bills not bearing the name of another credit institution,
- Transactions with recourse,
- Irrevocable standby letters of credit having the character of credit substitutes,
- Assets purchased under outright forward purchase agreements,
- Forward forward deposits,
- The unpaid portion of partly-paid shares and securities,
- Other items also carrying full risk.

Medium risk

- Documentary credits issued and confirmed (see also medium/low risk),
- Warranties and indemnities (including tender, performance, customs and tax bonds) and guarantees not having the character of credit substitutes,
- Asset sale and repurchase agreements as defined in Article 12(3) and (5) of Directive 86/635/EEC,
- Irrevocable standby letters of credit not having the character of credit substitutes,
- Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of more than one year,
- Note issuance facilities (NIFs) and revolving underwriting facilities (RUFs),
- Other items also carrying medium risk.

Medium/low risk

- Documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions,
- Other items also carrying medium/low risk.

Low risk

- Undrawn credit facilities (agreements to lend, purchase securities, provide guarantees or acceptance facilities) with an original maturity of up to and including one year or which may be cancelled unconditionally at any time without notice,
- Other items also carrying low risk.

The Member States undertake to inform the Commission as soon as they have agreed to include a new off-balance-sheet item in any of the last indents under each category of risk. Such items will be definitively classified at Community level once the procedure laid down in Article 60 has been completed.

ANNEX III

THE TREATMENT OF OFF-BALANCE-SHEET ITEMS

1. CHOICE OF THE METHOD

To measure the credit risks associated with the contracts listed in points 1 and 2 of Annex IV, credit institutions may choose, subject to the consent of the competent authorities, one of the methods set out below. Credit institutions which have to comply with Article 6(1) of Directive 93/6/EEC[1] must use method 1 set out below. To measure the credit risks associated with the contracts listed in point 3 of Annex IV all credit institutions must use method 1 set out below.

2. METHODS

Method 1: the "mark to market" approach

Step (a): by attaching current market values to contracts (mark to market), the current replacement cost of all contracts with positive values is obtained.

Step (b): to obtain a figure for potential future credit exposure[2], the notional principal amounts or underlying values are multiplied by the following percentages:

Table 1 1), 2)

Residual maturity 3)	Interest-rate contracts	Contracts concerning foreign-exchange rates and gold	Contracts concerning equities	Contracts concerning precious metals except gold	Contracts concerning commodities other than precious metals
One year or less	0%	1%	6%	7%	10%
Over one year, less than five years	0.5%	5%	8%	7%	12%
Over five years	1.5%	7.5%	10%	8%	15%

1) Contracts which do not fall within one of the five categories indicated in this table shall be treated as contracts concerning commodities other than precious metals.
2) For contracts with multiple exchanges of principal, the percentages have to be multiplied by the number of remaining payments still to be made according to the contract.
3) For contracts that are structured to settle outstanding exposure following specified payment dates and where the terms are reset such that the market value of the contract is zero on these specified dates, the residual maturity would be equal to the time until the next reset date. In the case of interest-rate contracts that meet these criteria and have a remaining maturity of over one year, the percentage shall be no lower than 0.5%.

For the purpose of calculating the potential future exposure in accordance with step (b) the competent authorities may allow credit institutions until 31 December 2006 to apply the following percentages instead of those prescribed in Table 1 provided that the institutions make use of the option set out in Article 11a of Directive 93/6/EEC for contracts within the meaning of paragraph 3(b) and (c) of Annex IV:

1 Council Directive 93/6/EEC of 15 March 1993 on the capital adequacy of investment firms and credit institutions (OJ L 141, 11.6.1993, p. 1). Directive amended by Directive 98/33/EC (OJ L 204, 21.7.1998, p. 29).

2 Except in the case of single-currency "floating/floating" interest rate swaps in which only the current replacement cost will be calculated.

Table 1a

Residual maturity	Precious metals (except gold)	Base metals	Agricultural products (softs)	Other, including energy products
One year or less	2%	2.5%	3%	4%
Over one year, less than five years	5%	4%	5%	6%
Over five years	7.5%	8%	9%	10%

Step (c): the sum of current replacement cost and potential future credit exposure is multiplied by the risk weightings allocated to the relevant counterparties in Article 43.

Method 2: the "original exposure" approach

Step (a): the notional principal amount of each instrument is multiplied by the percentages given below:

Table 2

Original maturity [1]	Interest-rate contracts	Contracts concerning foreign-exchange rates and gold
One year or less	0.5%	2%
More than one year but not exceeding two years	1%	5%
Additional allowance for each additional year	1%	3%

1) In the case of interest-rate contracts, credit institutions may, subject to the consent of their competent authorities, choose either original or residual maturity.

Step (b): the original exposure thus obtained is multiplied by the risk weightings allocated to the relevant counterparties in Article 43.

For methods 1 and 2 the competent authorities must ensure that the notional amount to be taken into account is an appropriate yardstick for the risk inherent in the contract. Where, for instance, the contract provides for a multiplication of cash flows, the notional amount must be adjusted in order to take into account the effects of the multiplication on the risk structure of that contract.

3. CONTRACTUAL NETTING (CONTRACTS FOR NOVATION AND OTHER NETTING AGREEMENTS)

(a) Types of netting that competent authorities may recognise

For the purpose of this point 3 "counterparty" means any entity (including natural persons) that has the power to conclude a contractual netting agreement.

The competent authorities may recognise as risk-reducing the following types of contractual netting:

(i) bilateral contracts for novation between a credit institution and its counterparty under which mutual claims and obligations are automatically amalgamated in such a way that this novation fixes one single net amount each time novation applies and thus creates a legally binding, single new contract extinguishing former contracts;

(ii) other bilateral agreements between a credit institution and its counterparty.

(b) Conditions for recognition

The competent authorities may recognise contractual netting as risk-reducing only under the following conditions:

(i) a credit institution must have a contractual netting agreement with its counterparty which creates a single legal obligation, covering all included transactions, such that, in the event of a counterparty's failure to perform owing to default, bankruptcy, liquidation or any other similar circumstance, the credit institution would have a claim to receive or an obligation to pay only the net sum of the positive and negative mark-to-market values of included individual transactions;

(ii) a credit institution must have made available to the competent authorities written and reasoned legal opinions to the effect that, in the event of a legal challenge, the relevant courts and administrative authorities would, in the cases described under (i), find that the credit institution's claims and obligations would be limited to the net sum, as described in (i), under:

- the law of the jurisdiction in which the counterparty is incorporated and, if a foreign branch of an undertaking is involved, also under the law of the jurisdiction in which the branch is located,
- the law that governs the individual transactions included, and
- the law that governs any contract or agreement necessary to effect the contractual netting;

(iii) a credit institution must have procedures in place to ensure that the legal validity of its contractual netting is kept under review in the light of possible changes in the relevant laws.

The competent authorities must be satisfied, if necessary after consulting the other competent authorities concerned, that the contractual netting is legally valid under the law of each of the relevant jurisdictions. If any of the competent authorities are not satisfied in that respect, the contractual netting agreement will not be recognised as risk-reducing for either of the counterparties.

The competent authorities may accept reasoned legal opinions drawn up by types of contractual netting.

No contract containing a provision which permits a non-defaulting counterparty to make limited payments only, or no payments at all, to the estate of the defaulter, even if the defaulter is a net creditor (a "walkaway" clause), may be recognised as risk-reducing.

The competent authorities may recognise as risk-reducing contractual-netting agreements covering foreign-exchange contracts with an original maturity of 14 calendar days or less written options or similar off-balance-sheet items to which this Annex does not apply because they bear only a negligible or no credit risk. If, depending on the positive or negative market value of these contracts, their inclusion in another netting agreement can result in an increase or decrease of the capital requirements, competent authorities must oblige their credit institution to use a consistent treatment.

(c) Effects of recognition

(i) Contracts for novation

The single net amounts fixed by contracts for novation, rather than the gross amounts involved, may be weighted. Thus, in the application of method 1, in

- step (a): the current replacement cost, and in
- step (b): the notional principal amounts or underlying values

may be obtained taking account of the contract for novation. In the application of method 2, in step (a) the notional principal amount may be calculated taking account of the contract for novation; the percentages of Table 2 must apply.

(ii) Other netting agreements

In application of method 1:

- in step (a) the current replacement cost for the contracts included in a netting agreement may be obtained by taking account of the actual hypothetical net replacement cost which results from the agreement; in the case where netting leads to a net obligation for the credit institution calculating the net replacement cost, the current replacement cost is calculated as "0",

– in step (b) the figure for potential future credit exposure for all contracts included in a netting agreement may be reduced according to the following equation:

$$PCE_{red} = 0.4 * PCE_{gross} + 0.6 * NGR * PCE_{gross}$$

where:

– PCE_{red} = the reduced figure for potential future credit exposure for all contracts with a given counterparty included in a legally valid bilateral netting agreement,

– PCE_{gross} = the sum of the figures for potential future credit exposure for all contracts with a given counterparty which are included in a legally valid bilateral netting agreement and are calculated by multiplying their notional principal amounts by the percentages set out in Table 1,

– NGR = "net-to-gross ratio": at the discretion of the competent authorities either:

(i) separate calculation: the quotient of the net replacement cost for all contracts included in a legally valid bilateral netting agreement with a given counterparty (numerator) and the gross replacement cost for all contracts included in a legally valid bilateral netting agreement with that counterparty (denominator), or

(ii) aggregate calculation: the quotient of the sum of the net replacement cost calculated on a bilateral basis for all counterparties taking into account the contracts included in legally valid netting agreements (numerator) and the gross replacement cost for all contracts included in legally valid netting agreements (denominator).

If Member States permit credit institutions a choice of methods, the method chosen is to be used consistently.

For the calculation of the potential future credit exposure according to the above formula perfectly matching contracts included in the netting agreement may be taken into account as a single contract with a notional principal equivalent to the net receipts. Perfectly matching contracts are forward foreign-exchange contracts or similar contracts in which a notional principal is equivalent to cash flows if the cash flows fall due on the same value date and fully or partly in the same currency.

In the application of method 2, in step (a)

– perfectly matching contracts included in the netting agreement may be taken into account as a single contract with a notional principal equivalent to the net receipts, the notional principal amounts are multiplied by the percentages given in Table 2,

– for all other contracts included in a netting agreement, the percentages applicable may be reduced as indicated in Table 3:

Table 3

Original maturity [1]	Interest-rate contracts	Foreign-exchange contracts
One year or less	0.35%	1.50%
More than one year but not more than two years	0.75%	3.75%
Additional allowance for each additional year	0.75%	2.25%

1) In the case of interest-rate contracts, credit institutions may, subject to the consent of their competent authorities, choose either original or residual maturity.

ANNEX IV

TYPES OF OFF-BALANCE-SHEET ITEMS

1. Interest-rate contracts:

(a) single-currency interest rate swaps;

(b) basis-swaps;

(c) forward rate agreements;

(d) interest-rate futures;

(e) interest-rate options purchased;

(f) other contracts of similar nature.

2. Foreign-exchange contracts and contracts concerning gold:

(a) cross-currency interest-rate swaps;

(b) forward foreign-exchange contracts;

(c) currency futures;

(d) currency options purchased;

(e) other contracts of a similar nature;

(f) contracts concerning gold of a nature similar to (a) to (e).

3. Contracts of a nature similar to those in points 1(a) to (e) and 2(a) to (d) concerning other reference items or indices concerning:

(a) equities;

(b) precious metals except gold;

(c) commodities other than precious metals;

(d) other contracts of a similar nature.

ANNEX V

PART A

REPEALED DIRECTIVES TOGETHER WITH THEIR SUCCESSIVE AMENDMENTS

(referred to in Article 67)

Council Directive 73/183/EEC

Council Directive 77/780/EEC

Council Directive 85/345/EEC

Council Directive 86/137/EEC

Council Directive 86/524/EEC

Council Directive 89/646/EEC

Directive 95/26/EC of the European Parliament and of the Council,

only Article 1, first indent, Article 2(1), first indent and (2), first indent, Article 3(2), Article 4(2), (3) and (4), as regards references to Directive 77/780/EEC, and (6), and Article 5, first indent

Council Directive 96/13/EC

Directive 98/33/EC of the European Parliament and of the Council

Council Directive 89/299/EEC

Council Directive 91/633/EEC

Council Directive 92/16/EEC

Council Directive 92/30/EEC

Council Directive 89/646/EEC

Council Directive 92/30/EEC

Directive 95/26/EC of the European Parliament and of the Council

only Article 1, first indent

Council Directive 89/647/EEC

Commission Directive 91/31/EEC

Council Directive 92/30/EEC

Commission Directive 94/7/EC

Commission Directive 95/15/EC

Commission Directive 95/67/EC

Directive 96/10/EC of the European Parliament and of the Council

Directive 98/32/EC of the European Parliament and of the Council

Directive 98/33/EC of the European Parliament and of the Council (Article 2)

Council Directive 92/30/EEC

Council Directive 92/121/EEC

Deadlines for implementation (referred to in Article 67)

Directive		Deadline for implementation
73/183/EEC (OJ L 194, 16.7.1973, p. 1)		2.1.1975 [1)]
77/780/EEC (OJ L 322, 17.12.1977, p. 30)		15.12.1979
85/345/EEC (OJ L 183, 16.7.1985, p. 19)		15.7.1985
86/137/EEC (OJ L 106, 23.4.1986, p. 35)		–
86/524/EEC (OJ L 309, 4.11.1986, p. 15)		31.12.1986
89/299/EEC (OJ L 124, 5.5.1989, p. 16)		1.1.1993
89/646/EEC (OJ L 386, 30.12.1989, p. 1)	Article 6(2), other provisions	1.1.1990 1.1.1993
89/647/EEC (OJ L 386, 30.12.1989, p. 14)		1.1.1991
91/31/EEC (OJ L 17, 23.1.1991, p. 20)		31.3.1991
91/633/EEC (OJ L 339, 11.12.1991, p. 16)		31.12.1992
92/16/EEC (OJ L 75, 31.3.1992, p. 48)		31.12.1992
92/30/EEC (OJ L 110, 28.4.1992, p.52)		31.12.1992
92/121/EEC (OJ L 29, 5.2.1993, p. 1)		31.12.1993
94/7/EC (OJ L 89, 6.4.1994, p. 17)		25.11.1994
95/15/EC (OJ L 125, 8.6.1995, p. 23)		30.9.1995
95/26/EC (OJ L 168, 18.7.1995, p. 7)		18.7.1996
95/67/EC (OJ L 314, 28.12.1995, p. 72)		1.7.1996
96/10/EC (OJ L 85, 3.4.1996, p. 17)		30.6.1996
96/13/EC (OJ L 66, 16.3.1996, p. 15)		15.4.1996
98/32/EC (OJ L 204, 21.7.1998, p. 26)		21.7.2000
98/33/EC (OJ L 204, 21.7.1998, p. 29)		21.7.2000

1) However, as regards the abolition of the restriction referred to in Article 3(2)(g), the Netherlands was allowed to defer implementation until 2 July 1977. (See: Article 8, second subparagraph of Directive 73/183/EEC).

ANNEX VI

Correlation table

This Directive	Directive 77/780/EEC	Directive 89/299/EEC	Directive 89/646/EEC	Directive 89/647/EEC	Directive 92/30/EEC	Directive 92/121/EEC	Directive 96/10/EC
Article 1(1)	Article 1, first indent				Article 1, first indent	Article 1(a)	
Article 1(2)	Article 1, second indent						
Article 1(3)			Article 1(3)				
Article 1(4) to (8)			Article 1(5) to (9)				
Article 1(9)					Article 1, sixth indent		
Article 1(10) and (11)			Article 1(10) and (11)				
Article 1(12)			Article 1(12)		Article 1, seventh indent	Article 1(c)	
Article 1(13)			Article 1(13)		Article 1, eighth indent	Article 1(d)	
Article 1(14) to (17)				Article 2(1), second to fifth indents			
Article 1(18) to (20)				Article 2(1), sixth to eighth indents			
Article 1(21) to (23)					Article 1, third to fifth indents		
Article 1(24)						Article 1(h)	
Article 1(25)						Article 1(m)	
Article 1(26)	Article 1, fifth indent						
Article 1(27)				Article 2(1), ninth indent			
Article 2(1)	Article 2(1)		Article 2(1)	Article 1(1)			
Article 2(2)					Article 2		
Article 2(3)	Article 2(2)						
Article 2(4)	Article 2(3)						
Article 2(5), first, second and third sub-paragraph	Article 2(4) (a), (b) and (c)						
Article 2(6)			Article 2(3)	Article 1(3)		Article 2(2)(b)	
Article 3			Article 3				
Article 4	Article 3(1)						
Article 5(1), first sub-paragraph	Article 3(2), first sub-paragraph		Article 4(1)				
Article 5(1), second sub-paragraph	Article 10(1), third sub-paragraph						
Article 5(2)			Article 4(2), introductory sentence, (a), (b) and (c)				
Article 5(3) to (7)			Article 10(1) to (5)				

Correlation table (cont'd)

This Directive	Directive 77/780/EEC	Directive 89/299/EEC	Directive 89/646/EEC	Directive 89/647/EEC	Directive 92/30/EEC	Directive 92/121/EEC	Directive 96/10/EC
Article 6(1)	Article 3(2), first subparagraph, third indent and second subparagraph						
Article 6(2)	Article 3(2)a						
Article 7(1) and (2)			Article 1(10), second subparagraph and Article 5(1) and (2)				
Article 7(3)	Article 3(2) third, fourth and fifth subparagraphs						
Article 8	Article 3(4)						
Article 9	Article 3(3)(a)						
Article 10	Article 3(6)						
Article 11	Article 3(7)						
Article 12			Article 7				
Article 13			Article 6(1)				
Article 14(1)	Article 8(1)						
Article 14(2)	Article 8(5)						
Article 15	Article 5						
Article 16(1) to (5)			Article 11(1) to (5)				
Article 16(6)			Article 1(10), second subparagraph				
Article 17			Article 13(2)				
Article 18			Article 18(1)				
Article 19			Article 18(2)				
Article 20(1) to (6)			Article 19				
Article 20(7)			Article 23(1)				
Article 21(1) and (2)			Article 20				
Article 21(3)			Article 23(2)				
Article 22			Article 21				
Article 23(1)			Article 8				
Article 23(2) to (7)			Article 9				
Article 24	Article 9						
Article 25					Article 8		
Article 26			Article 13(1) and (3)				
Article 27			Article 14(2)				
Article 28	Article 7(1)						
Article 29			Article 15				
Article 30(1) to (5)	Article 12(1) to (5)						
Article 30(6)	Article 12(5a)						
Article 30(7)	Article 12(5b)						
Article 30(8)	Article 12(6)						

Correlation table (cont'd)

This Directive	Directive 77/780/EEC	Directive 89/299/EEC	Directive 89/646/EEC	Directive 89/647/EEC	Directive 92/30/EEC	Directive 92/121/EEC	Directive 96/10/EC
Article 30(9)	Article 12(7)						
Article 30(10)	Article 12(8)						
Article 31	Article 12a						
Article 32			Article 17				
Article 33	Article 13						
Article 34(1)		Article 1(1)					
Article 34(2) to (4)		Article 2(1) to (3)					
Article 35		Article 3					
Article 36		Article 4					
Article 37		Article 5					
Article 38		Article 6(1) and (4)					
Article 39		Article 7					
Article 40				Article 3(1) to (4), (7) and (8)			
Article 41				Article 4			
Article 42				Article 5			
Article 43				Article 6			
Article 44				Article 7			
Article 45				Article 8			
Article 46				Article 2(2)			
Article 47				Article 10			
Article 48						Article 3	
Article 49						Article 4(1) to (7)(r), second subparagraph, first sentence, and (7)(s) to (12)	
Article 50						Article 5(1) to (3)	
Article 51(1) to (5)			Article 12(1) to (5)				
Article 51(6)			Article 12(8)				
Article 52(1) to (7)					Article 3(1) to (7)		
Article 52(8) and (9)				Article 3(5) and (6)	Article 3(8) and (9)	Article 5(4) and (5)	
Article 52(10)					Article 3(10)		
Article 53					Article 4		
Article 54					Article 5		
Article 55					Article 6		
Article 56					Article 7		
Article 57	Article 11						
Article 58	Article 3(5)						
Article 59	Article 6						
Article 60		Article 8	Article 22	Article 9		Article 7	
Article 61		Article 4a					
Article 62(1) and (2)				Article 11(4) and (5)			
Article 62(3)							Article 2

Correlation table (cont'd)

This Directive	Directive 77/780/EEC	Directive 89/299/EEC	Directive 89/646/EEC	Directive 89/647/EEC	Directive 92/30/EEC	Directive 92/121/EEC	Directive 96/10/EC
Article 63				Article 11(1) to (3)			
Article 64						Article 6(1) to (9)	
Article 65			Article 12(7)				
Article 66	Article 14(2)	Article 9(2)	Article 24(3)	Article 12(2)			
Article 67	–	–	–	–	–	–	–
Article 68	–	–	–	–	–	–	–
Article 69	–	–	–	–	–	–	–
Annex I			Annex				
Annex II				Annex I			
Annex III				Annex II			
Annex IV				Annex III			
Annex V	–	–	–	–	–	–	–
Annex VI	–	–	–	–	–	–	–

ANNEX 6

DIRECTIVE 94/19/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL OF 30 MAY 1994 ON DEPOSIT-GUARANTEE SCHEMES*

This annex contains a replication of the above mentioned directive.

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION

Having regard to the Treaty establishing the European Community, and in particular the first and third sentences of Article 57 (2) thereof,

Having regard to the proposal from the Commission[1],

Having regard to the opinion of the Economic and Social Committee[2],

Acting in accordance with the procedure referred to in Article 189b of the Treaty[3],

Whereas, in accordance with the objectives of the Treaty, the harmonious development of the activities of credit institutions throughout the Community should be promoted through the elimination of all restrictions on the right of establishment and the freedom to provide services, while increasing the stability of the banking system and protection for savers;

Whereas, when restrictions on the activities of credit institutions are eliminated, consideration should be given to the situation which might arise if deposits in a credit institution that has branches in other Member States become unavailable; whereas it is indispensable to ensure a harmonized minimum level of deposit protection wherever deposits are located in the Community; whereas such deposit protection is as essential as the prudential rules for the completion of the single banking market;

Whereas in the event of the closure of an insolvent credit institution the depositors at any branches situated in a Member State other than that in which the credit institution has its head office must be protected by the same guarantee scheme as the institution's other depositors;

Whereas the cost to credit institutions of participating in a guarantee scheme bears no relation to the cost that would result from a massive withdrawal of bank deposits not only from a credit institution in difficulties but also from healthy institutions following a loss of depositor confidence in the soundness of the banking system;

Whereas the action the Member States have taken in response to Commission recommendation 87/63/EEC of 22 December 1986 concerning the introduction of deposit-guarantee schemes in the Community[4] has not fully achieved the desired result; whereas that situation may prove prejudicial to the proper functioning of the internal market;

Whereas the Second Council Directive 89/646/EEC of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC[5], provides for a system for the single authorization of each credit institution and its supervision by the authorities of its home Member State, which entered into force on 1 January 1993;

Whereas a branch no longer requires authorization in any host Member State, because the single authorization is valid throughout the Community, and its solvency will be monitored by the competent authorities of its home Member State; whereas that situation justifies covering all the branches of the same credit institution set up in the Community by means of a single guarantee

* Official Journal L 135, 31/05/1994 P. 0005-0014.

1 OJ No C 163, 30. 6. 1992, p. 6 and OJ No C 178, 30. 6. 1993, p. 14.

2 OJ No C 332, 16. 12. 1992, p. 13.

3 OJ No C 115, 26. 4. 1993, p. 96 and Decision of the European Parliament of 9 March 1994 (OJ No C 91, 28. 3. 1994).

4 OJ No L 33, 4. 2. 1987, p. 16.

5 OJ No L 386, 30. 12. 1989, p. 1. Directive as amended by Directive 92/30/EEC (OJ No L 110, 28. 4. 1992, p. 52).

scheme; whereas that scheme can only be that which exists for that category of institution in the State in which that institution's head office is situated, in particular because of the link which exists between the supervision of a branch's solvency and its membership of a deposit-guarantee scheme;

Whereas harmonization must be confined to the main elements of deposit-guarantee schemes and, within a very short period, ensure payments under a guarantee calculated on the basis of a harmonized minimum level;

Whereas deposit-guarantee schemes must intervene as soon as deposits become unavailable;

Whereas it is appropriate to exclude from cover, in particular, the deposits made by credit institutions on their own behalf and for own account; whereas that should not prejudice the right of a guarantee scheme to take any measures necessary for the rescue of a credit institution that finds itself in difficulties,

Whereas the harmonization of deposit-guarantee schemes within the Community does not of itself call into question the existence of systems in operation designed to protect credit institutions, in particular by ensuring their solvency and liquidity, so that deposits with such credit institutions, including their branches established in other Member States, will not become unavailable; whereas such alternative systems serving a different protective purpose may, subject to certain conditions, be deemed by the competent authorities to satisfy the objectives of this Directive; whereas it will be for those competent authorities to verify compliance with those conditions;

Whereas several Member States have deposit-protection schemes under the responsibility of professional organizations, other Member States have schemes set up and regulated on a statutory basis and some schemes, although set up on a contractual basis, are partly regulated by statute; whereas that variety of status poses a problem only with regard to compulsory membership of and exclusion from schemes; whereas it is therefore necessary to take steps to limit the powers of schemes in this area;

Whereas the retention in the Community of schemes providing cover for deposits which is higher than the harmonized minimum may, within the same territory, lead to disparities in compensation and unequal conditions of competition between national institutions and branches of institutions from other Member States; whereas, in order to counteract those disadvantages, branches should be authorized to join their host countries' schemes so that they can offer their depositors the same guarantees as are offered by the schemes of the countries in which they are located; whereas it is appropriate that after a number of years the Commission should report on the extent to which branches have made use of this option and on the difficulties which they or the guarantee schemes may have encountered in implementing these provisions; whereas it is not ruled out that home Member State schemes should themselves offer such complementary cover, subject to the conditions such schemes may lay down;

Whereas market disturbances could be caused by branches of credit institutions which offer levels of cover higher than those offered by credit institutions authorized in their host Member States; whereas it is not appropriate that the level of scope of cover offered by guarantee schemes should become an instrument of competition; whereas it is therefore necessary, at least during an initial period, to stipulate that the level and scope of cover offered by a home Member State scheme to depositors at branches located in another Member State should not exceed the maximum level and scope offered by the corresponding scheme in the host Member State; whereas possible market disturbances should be reviewed after a number of years, on the basis of the experience acquired and in the light of developments in the banking sector;

Whereas in principle this Directive requires every credit institution to join a deposit-guarantee scheme; whereas the Directives governing the admission of any credit institution which has its head office in a non-member country, and in particular the First Council Directive (77/780/EEC) of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating

6 OJ No L 322, 17. 12. 1977, p. 30. Directive as last amended by Directive 89/646/EEC (OJ No L 386, 30. 12. 1989, p. 1).

to the taking up and pursuit of the business of credit institutions[6] allow Member States to decide whether and subject to what conditions to permit the branches of such credit institutions to operate within their territories; whereas such branches will not enjoy the freedom to provide services under the second paragraph of Article 59 of the Treaty, nor the right of establishment in Member States other than those in which they are established; whereas, accordingly, a Member State admitting such branches should decide how to apply the principles of this Directive to such branches in accordance with Article 9 (1) of Directive 77/780/EEC and with the need to protect depositors and maintain the integrity of the financial system; whereas it is essential that depositors at such branches should be fully aware of the guarantee arrangements which affect them;

Whereas, on the one hand, the minimum guarantee level prescribed in this Directive should not leave too great a proportion of deposits without protection in the interest both of consumer protection and of the stability of the financial system; whereas, on the other hand, it would not be appropriate to impose throughout the Community a level of protection which might in certain cases have the effect of encouraging the unsound management of credit institutions; whereas the cost of funding schemes should be taken into account; whereas it would appear reasonable to set the harmonized minimum guarantee level at ECU 20 000; whereas limited transitional arrangements might be necessary to enable schemes to comply with that figure;

Whereas some Member States offer depositors cover for their deposits which is higher than the harmonized minimum guarantee level provided for in this Directive; whereas it does not seem appropriate to require that such schemes, certain of which have been introduced only recently pursuant to recommendation 87/63/EEC, be amended on this point;

Whereas a Member State must be able to exclude certain categories of specifically listed deposits or depositors, if it does not consider that they need special protection, from the guarantee afforded by deposit-guarantee schemes;

Whereas in certain Member States, in order to encourage depositors to look carefully at the quality of credit institutions, unavailable deposits are not fully reimbursed; whereas such practices should be limited in respect of deposits falling below the minimum harmonized level;

Whereas the principle of a harmonized minimum limit per depositor rather than per deposit has been retained; whereas it is therefore appropriate to take into consideration the deposits made by depositors who either are not mentioned as holders of an account or are not the sole holders; whereas the limit must therefore be applied to each identifiable depositor; whereas that should not apply to collective investment undertakings subject to special protection rules which do not apply to the aforementioned deposits;

Whereas information is an essential element in depositor protection and must therefore also be the subject of a minimum number of binding provisions; whereas, however, the unregulated use in advertising of references to the amount and scope of a deposit-guarantee scheme could affect the stability of the banking system or depositor confidence; whereas Member States should therefore lay down rules to limit such references;

Whereas, in specific cases, in certain Member States in which there are no deposit-guarantee schemes for certain classes of credit institutions which take only an extremely small proportion of deposits, the introduction of such a system may in some cases take longer than the time laid down for the transposition of this Directive; whereas in such cases a transitional derogation from the requirement to belong to a deposit-guarantee scheme may be justified; whereas, however, should such credit institutions operate abroad, a Member State would be entitled to require their participation in a deposit-guarantee scheme which it had set up;

Whereas it is not indispensable, in this Directive, to harmonize the methods of financing schemes guaranteeing deposits or credit institutions themselves, given, on the one hand, that the cost of financing such schemes must be borne, in principle, by credit institutions themselves and, on the other hand, that the financing capacity of such schemes must be in proportion to their liabilities; whereas this must not, however, jeopardize the stability of the banking system of the Member State concerned;

Whereas this Directive may not result in the Member States' or their competent authorities' being made liable in respect of depositors if they have ensured that one or more schemes guaranteeing deposits or credit institutions themselves and ensuring the compensation or protection of depositors under the conditions prescribed in this Directive have been introduced and officially recognized;

Whereas deposit protection is an essential element in the completion of the internal market and an indispensable supplement to the system of supervision of credit institutions on account of the solidarity it creates amongst all the institutions in a given financial market in the event of the failure of any of them,

HAS ADOPTED THIS DIRECTIVE:

Article 1

For the purposes of this Directive:

1. 'deposit' shall mean any credit balance which results from funds left in an account or from temporary situations deriving from normal banking transactions and which a credit institution must repay under the legal and contractual conditions applicable, and any debt evidenced by a certificate issued by a credit institution.

Shares in United Kingdom and Irish building societies apart from those of a capital nature covered in Article 2 shall be treated as deposits.

Bonds which satisfy the conditions prescribed in Article 22 (4) of Council Directive 85/611/EEC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (Ucits)[7] shall not be considered deposits.

For the purpose of calculating a credit balance, Member States shall apply the rules and regulations relating to set-off and counterclaims according to the legal and contractual conditions applicable to a deposit;

2. 'joint account' shall mean an account opened in the names of two or more persons or over which two or more persons have rights that may operate against the signature of one or more of those persons;

3. 'unavailable deposit' shall mean a deposit that is due and payable but has not been paid by a credit institution under the legal and contractual conditions applicable thereto, where either:

(i) the relevant competent authorities have determined that in their view the credit institution concerned appears to be unable for the time being, for reasons which are directly related to its financial circumstances, to repay the deposit and to have no current prospect of being able to do so.

The competent authorities shall make that determination as soon as possible and at the latest 21 days after first becoming satisfied that a credit institution has failed to repay deposits which are due and payable; or (ii) a judicial authority has made a ruling for reasons which are directly related to the credit institution's financial circumstances which has the effect of suspending depositors' ability to make claims against it, should that occur before the aforementioned determination has been made;

4. 'credit institution' shall mean an undertaking the business of which is to receive deposits or other repayable funds from the public and to grant credits for its own account;

5. 'branch' shall mean a place of business which forms a legally dependent part of a credit institution and which conducts directly all or some of the operations inherent in the business of credit institutions; any number of branches set up in the same Member State by a credit institution which has its head office in another Member State shall be regarded as a single branch.

7 OJ No L 375, 31. 12. 1985, p. 3. Directive as last amended by Directive 88/220/EEC (OJ No L 100, 19. 4. 1988, p. 31.).

Article 2

The following shall be excluded from any repayment by guarantee schemes:

– subject to Article 8 (3), deposits made by other credit institutions on their own behalf and for their own account,

– all instruments which would fall within the definition of 'own funds' in Article 2 of Council Directive 89/299/EEC of 17 April 1989 on the own funds of credit institutions[8],

– deposits arising out of transactions in connection with which there has been a criminal conviction for money laundering as defined in Article 1 of Council Directive 91/308/EEC of 10 June 1991 on prevention of the use of the financial system for the purpose of money laundering[9].

Article 3

1. Each Member State shall ensure that within its territory one or more deposit-guarantee schemes are introduced and officially recognized. Except in the circumstances envisaged in the second subparagraph and in paragraph 4, no credit institution authorized in that Member State pursuant to Article 3 of Directive 77/780/EEC may take deposits unless it is a member of such a scheme.

A Member State may, however, exempt a credit institution from the obligation to belong to a deposit-guarantee scheme where that credit institution belongs to a system which protects the credit institution itself and in particular ensures its liquidity and solvency, thus guaranteeing protection for depositors at least equivalent to that provided by a deposit-guarantee scheme, and which, in the opinion of the competent authorities, fulfils the following conditions:

– the system must be in existence and have been officially recognized when this Directive is adopted,

– the system must be designed to prevent deposits with credit institutions belonging to the system from becoming unavailable and have the resources necessary for that purpose at its disposal,

– the system must not consist of a guarantee granted to a credit institution by a Member State itself or by any of its local or regional authorities,

– the system must ensure that depositors are informed in accordance with the terms and conditions laid down in Article 9.

Those Member States which make use of this option shall inform the Commission accordingly; in particular, they shall notify the Commission of the characteristics of any such protective systems and the credit institutions covered by them and of any subsequent changes in the information supplied. The Commission shall inform the Banking Advisory Committee thereof.

2. If a credit institution does not comply with the obligations incumbent on it as a member of a deposit-guarantee scheme, the competent authorities which issued its authorization shall be notified and, in collaboration with the guarantee scheme, shall take all appropriate measures including the imposition of sanctions to ensure that the credit institution complies with its obligations.

3. If those measures fail to secure compliance on the part of the credit institution, the scheme may, where national law permits the exclusion of a member, with the express consent of the competent authorities, give not less than 12 months' notice of its intention of excluding the credit institution from membership of the scheme. Deposits made before the expiry of the notice period shall continue to be fully covered by the scheme. If, on the expiry of the notice period, the credit institution has not complied with its obligations, the guarantee scheme may, again having obtained the express consent of the competent authorities, proceed to exclusion.

8 OJ No L 124, 5. 5. 1989, p. 16. Directive is last amended by Directive 92/16/EEC (OJ No L 75, 21. 3. 1992, p. 48).

9 OJ No L 166, 28. 6. 1991, p. 77.

4. Where national law permits, and with the express consent of the competent authorities which issued its authorization, a credit institution excluded from a deposit-guarantee scheme may continue to take deposits if, before its exclusion, it has made alternative guarantee arrangements which ensure that depositors will enjoy a level and scope of protection at least equivalent to that offered by the officially recognized scheme.

5. If a credit institution the exclusion of which is proposed under paragraph 3 is unable to make alternative arrangements which comply with the conditions prescribed in paragraph 4, then the competent authorities which issued its authorization shall revoke it forthwith.

Article 4

1. Deposit-guarantee schemes introduced and officially recognized in a Member State in accordance with Article 3 (1) shall cover the depositors at branches set up by credit institutions in other Member States.

Until 31 December 1999 neither the level nor the scope, including the percentage, of cover provided shall exceed the maximum level or scope of cover offered by the corresponding guarantee scheme within the territory of the host Member State.

Before that date, the Commission shall draw up a report on the basis of the experience acquired in applying the second subparagraph and shall consider the need to continue those arrangements. If appropriate, the Commission shall submit a proposal for a Directive to the European Parliament and the Council, with a view to the extension of their validity.

2. Where the level and/or scope, including the percentage, of cover offered by the host Member State guarantee scheme exceeds the level and/or scope of cover provided in the Member State in which a credit institution is authorized, the host Member State shall ensure that there is an officially recognized deposit-guarantee scheme within its territory which a branch may join voluntarily in order to supplement the guarantee which its depositors already enjoy by virtue of its membership of its home Member State scheme.

The scheme to be joined by the branch shall cover the category of institution to which it belongs or most closely corresponds in the host Member State.

3. Member States shall ensure that objective and generally applied conditions are established for branches' membership of a host Member State's scheme in accordance with paragraph 2. Admission shall be conditional on fulfilment of the relevant obligations of membership, including in particular payment of any contributions and other charges. Member States shall follow the guiding principles set out in Annex II in implementing this paragraph.

4. If a branch granted voluntary membership under paragraph 2 does not comply with the obligations incumbent on it as a member of a deposit-guarantee scheme, the competent authorities which issued the authorization shall be notified and, in collaboration with the guarantee scheme, shall take all appropriate measures to ensure that the aforementioned obligations are complied with.

If those measures fail to secure the branch's compliance with the aforementioned obligations, after an appropriate period of notice of not less than 12 months the guarantee scheme may, with the consent of the competent authorities which issued the authorization, exclude the branch. Deposits made before the date of exclusion shall continue to be covered by the voluntary scheme until the dates on which they fall due. Depositors shall be informed of the withdrawal of the supplementary cover.

5. The Commission shall report on the operation of paragraphs 2, 3 and 4 no later than 31 December 1999 and shall, if appropriate, propose amendments thereto.

Article 5

Deposits held when the authorization of a credit institution authorized pursuant to Article 3 of Directive 77/780/EEC is withdrawn shall continue to be covered by the guarantee scheme.

Article 6

1. Member States shall check that branches established by a credit institution which has its head office outwith the Community have cover equivalent to that prescribed in this Directive.

Failing that, Member States may, subject to Article 9 (1) of Directive 77/780/EEC, stipulate that branches established by a credit institution which has its head office outwith the Community must join deposit-guarantee schemes in operation within their territories.

2. Actual and intending depositors at branches established by a credit institution which has its head office outwith the Community shall be provided by the credit institution with all relevant information concerning the guarantee arrangements which cover their deposits.

3. The information referred to in paragraph 2 shall be made available in the official language or languages of the Member State in which a branch is established in the manner prescribed by national law and shall be drafted in a clear and comprehensible form.

Article 7

1. Deposit-guarantee schemes shall stipulate that the aggregate deposits of each depositor must be covered up to ECU 20 000 in the event of deposits' being unavailable.

Until 31 December 1999 Member States in which, when this Directive is adopted, deposits are not covered up to ECU 20 000 may retain the maximum amount laid down in their guarantee schemes, provided that this amount is not less than ECU 15 000.

2. Member States may provide that certain depositors or deposits shall be excluded from guarantee or shall be granted a lower level of guarantee. Those exclusions are listed in Annex I.

3. This Article shall not preclude the retention or adoption of provisions which offer a higher or more comprehensive cover for deposits. In particular, deposit-guarantee schemes may, on social considerations, cover certain kinds of deposits in full.

4. Member States may limit the guarantee provided for in paragraph 1 or that referred to in paragraph 3 to a specified percentage of deposits. The percentage guaranteed must, however, be equal to or exceed 90 % of aggregate deposits until the amount to be paid under the guarantee reaches the amount referred to in paragraph 1.

5. The amount referred to in paragraph 1 shall be reviewed periodically by the Commission at least once every five years. If appropriate, the Commission shall submit to the European Parliament and to the Council a proposal for a Directive to adjust the amount referred to in paragraph 1, taking account in particular of developments in the banking sector and the economic and monetary situation in the Community. The first review shall not take place until five years after the end of the period referred to in Article 7 (1), second subparagraph.

6. Member States shall ensure that the depositor's rights to compensation may be the subject of an action by the depositor against the deposit-guarantee scheme.

Article 8

1. The limits referred to in Article 7 (1), (3) and (4) shall apply to the aggregate deposits placed with the same credit institution irrespective of the number of deposits, the currency and the location within the Community.

2. The share of each depositor in a joint account shall be taken into account in calculating the limits provided for in Article 7 (1), (3) and (4).

In the absence of special provisions, such an account shall be divided equally amongst the depositors.

Member States may provide that deposits in an account to which two or more persons are entitled as members of a business partnership, association or grouping of a similar nature, without legal

personality, may be aggregated and treated as if made by a single depositor for the purpose of calculating the limits provided for in Article 7 (1), (3) and (4).

3. Where the depositor is not absolutely entitled to the sums held in an account, the person who is absolutely entitled shall be covered by the guarantee, provided that that person has been identified or is identifiable before the date on which the competent authorities make the determination described in Article 1 (3) (i) or the judicial authority makes the ruling described in Article 1 (3) (ii). If there are several persons who are absolutely entitled, the share of each under the arrangements subject to which the sums are managed shall be taken into account when the limits provided for in Article 7 (1), (3) and (4) are calculated.

This provision shall not apply to collective investment undertakings.

Article 9

1. Member States shall ensure that credit institutions make available to actual and intending depositors the information necessary for the identification of the deposit-guarantee scheme of which the institution and its branches are members within the Community or any alternative arrangement provided for in Article 3 (1), second subparagraph, or Article 3 (4). The depositors shall be informed of the provisions of the deposit-guarantee scheme or any alternative arrangement applicable, including the amount and scope of the cover offered by the guarantee scheme. That information shall be made available in a readily comprehensible manner.

Information shall also be given on request on the conditions for compensation and the formalities which must be completed to obtain compensation.

2. The information provided for in paragraph 1 shall be made available in the manner prescribed by national law in the official language or languages of the Member State in which the branch is established.

3. Member States shall establish rules limiting the use in advertising of the information referred to in paragraph 1 in order to prevent such use from affecting the stability of the banking system or depositor confidence. In particular, Member States may restrict such advertising to a factual reference to the scheme to which a credit institution belongs.

Article 10

1. Deposit-guarantee schemes shall be in a position to pay duly verified claims by depositors in respect of unavailable deposits within three months of the date on which the competent authorities make the determination described in Article 1 (3) (i) or the judicial authority makes the ruling described in Article 1 (3) (ii).

2. In wholly exceptional circumstances and in special cases a guarantee scheme may apply to the competent authorities for an extension of the time limit. No such extension shall exceed three months. The competent authorities may, at the request of the guarantee scheme, grant no more than two further extensions, neither of which shall exceed three months.

3. The time limit laid down in paragraphs 1 and 2 may not be invoked by a guarantee scheme in order to deny the benefit of guarantee to any depositor who has been unable to assert his claim to payment under a guarantee in time.

4. The documents relating to the conditions to be fulfilled and the formalities to be completed to be eligible for a payment under the guarantee referred to in paragraph 1 shall be drawn up in detail in the manner prescribed by national law in the official language or languages of the Member State in which the guaranteed deposit is located.

5. Notwithstanding the time limit laid down in paragraphs 1 and 2, where a depositor or any person entitled to or interested in sums held in an account has been charged with an offence arising out of or in relation to money laundering as defined in Article 1 of Directive 91/308/EEC, the guarantee scheme may suspend any payment pending the judgment of the court.

Article 11

Without prejudice to any other rights which they may have under national law, schemes which make payments under guarantee shall have the right of subrogation to the rights of depositors in liquidation proceedings for an amount equal to their payments.

Article 12

Notwithstanding Article 3, those institutions authorized in Spain or in Greece and listed in Annex III shall be exempt from the requirement to belong to a deposit-guarantee scheme until 31 December 1999.

Such credit institutions shall expressly alert their actual and intending depositors to the fact that they are not members of any deposit-guarantee scheme.

During that time, should any such credit institution establish or have established a branch in another Member State, that Member State may require that branch to belong to a deposit-guarantee scheme set up within its territory under conditions consonant with those prescribed in Article 4 (2), (3) and (4).

Article 13

In the list of authorized credit institutions which it is required to draw up pursuant to Article 3 (7) of Directive 77/780/EEC the Commission shall indicate the status of each credit institution with regard to this Directive.

Article 14

1. The Member States shall bring into force the laws, regulations and administrative provisions necessary for them to comply with this Directive by 1 July 1995. They shall forthwith inform the Commission thereof.

When the Member States adopt these measures they shall contain a reference to this Directive or shall be accompanied by such reference on the occasion of their official publication. The methods of making such reference shall be laid down by the Member States.

2. The Member States shall communicate to the Commission the texts of the main provisions of national law which they adopt in the field governed by this Directive.

Article 15

This Directive shall enter into force on the day of its publication in the Official Journal of the European Communities.

Article 16

This Directive is addressed to the Member States.

Done at Brussels, 30 May 1994.

For the European Parliament	For the Council
The President	The President
E. KLEPSCH	G. ROMEOS

ANNEX I

LIST OF EXCLUSIONS REFERRED TO IN ARTICLE 7 (2)

1. Deposits by financial institutions as defined in Article 1 (6) of Directive 89/646/EEC.

2. Deposits by insurance undertakings.

3. Deposits by government and central administrative authorities.

4. Deposits by provincial, regional, local and municipal authorities.

5. Deposits by collective investment undertakings.

6. Deposits by pension and retirement funds.

7. Deposits by a credit institution's own directors, managers, members personally liable, holders of at least 5% of the credit institution's capital, persons responsible for carrying out the statutory audits of the credit institution's accounting documents and depositors of similar status in other companies in the same group.

8. Deposits by close relatives and third parties acting on behalf of the depositors referred to in 7.

9. Deposits by other companies in the same group.

10. Non-nominative deposits.

11. Deposits for which the depositor has, on an individual basis, obtained from the same credit institution rates and financial concessions which have helped to aggravate its financial situation.

12. Debt securities issued by the same institution and liabilities arising out of own acceptances and promissory notes.

13. Deposits in currencies other than:

– those of the Member States,

– ecus.

14. Deposits by companies which are of such a size that they are not permitted to draw up abridged balance sheets pursuant to Article 11 of the Fourth Council Directive (78/660/EEC) of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies 1[10].

ANNEX II

GUIDING PRINCIPLES

Where a branch applies to join a host Member State scheme for supplementary cover, the host Member State scheme will bilaterally establish with the home Member State scheme appropriate rules and procedures for paying compensation to depositors at that branch. The following principles shall apply both to the drawing up of those procedures and in the framing of the membership conditions applicable to such a branch (as referred to in Article 4 (2)):

(a) the host Member State scheme will retain full rights to impose its objective and generally applied rules on participating credit institutions; it will be able to require the provision of relevant information and have the right to verify such information with the home Member State's competent authorities;

10 OJ No L 222, 14. 8. 1978, p. 11. Directive as last amended by Directive 90/605/EEC (OJ No L 317, 16. 11. 1990, p. 60).

(b) the host Member State scheme will meet claims for supplementary compensation upon a declaration from the home Member State's competent authorities that deposits are unavailable. The host Member State scheme will retain full rights to verify a depositor's entitlement according to its own standards and procedures before paying supplementary compensation;

(c) home Member State and host Member State schemes will cooperate fully with each other to ensure that depositors receive compensation promptly and in the correct amounts. In particular, they will agree on how the existence of a counterclaim which may give rise to set-off under either scheme will affect the compensation paid to the depositor by each scheme;

(d) host Member State schemes will be entitled to charge branches for supplementary cover on an appropriate basis which takes into account the guarantee funded by the home Member State scheme. To facilitate charging, the host Member State scheme will be entitled to assume that its liability will in all circumstances be limited to the excess of the guarantee it has offered over the guarantee offered by the home Member State regardless of whether the home Member State actually pays any compensation in respect of deposits held within the host Member State's territory.

ANNEX III

LIST OF CREDIT INSTITUTIONS MENTIONED IN ARTICLE 12

(a) Specialized classes of Spanish institutions, the legal status of which is currently undergoing reform, authorized as

- Entidades de Financiación o Factoring,
- Sociedades de Arrendamiento Financiero,
- Sociedades de Crédito Hipotecario.

(b) The following Spanish state institutions:

- Banco de Crédito Agrícola, SA,
- Banco Hipotecario de España, SA,
- Banco de Crédito Local, SA.

(c) The following Greek credit cooperatives:

- Lamia Credit Cooperative,
- Ioannina Credit Cooperative,
- Xylocastron Credit Cooperative,

as well as those of the credit cooperatives of a similar nature listed below which are authorized or in the process of being authorized on the date of the adoption of this Directive:

- Chania Credit Cooperative,
- Iraklion Credit Cooperative,
- Magnissia Credit Cooperative,
- Larissa Credit Cooperative,
- Patras Credit Cooperative,
- Thessaloniki Credit Cooperative.

ANNEX 7

THE BASEL COMMITTEE ON BANKING SUPERVISION: CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION, SEPTEMBER 1997

This annex contains a replication of the above mentioned document by the Basel Committee. The full publication is available free of charge on the Bank for International Settlements' website.

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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. Several official bodies, including the Basle Committee on Banking Supervision, the Bank for International Settlements, the International Monetary Fund and the World Bank, have recently been examining ways to strengthen financial stability throughout the world.

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 and a half, 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) (attached); and,

– a *Compendium* (to be updated periodically) of the existing Basle Committee recommendations, guidelines and standards most of which are cross-referenced in the Core Principles document.

Both documents have been endorsed by the G-10 central bank Governors. They were submitted to the G-7 and G-10 Finance Ministers in preparation for the June 1997 Denver Summit in the hope that they would 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. Nine other countries (Argentina, 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 individual supervisors, both directly and through the regional supervisory groups.

4. 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

2 In countries where non-bank financial institutions provide financial services similar to those of banks, many of the Principles set out in this document are also capable of application to such non-bank financial institutions.

3 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, EMEAP Study Group on Banking Supervision, 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.

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 banking organisations. 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 organisations 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 banking organisation'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 prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

7. An essential part of any supervisory system is the 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 loan loss 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 appropriate 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 group 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 timely 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. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

Cross-border Banking
23. Banking supervisors must practise global consolidated supervision over their internationally-active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures 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.

I INTRODUCTION

Effective supervision of banking organisations 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 maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors;
- 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)[4] 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, particularly where the operations of banking organisations 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.

4 This document refers to a management structure composed of a board of directors and senior management. The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the notions of the board of directors and the senior management are used in this document not to identify legal constructs but rather to label two decision-making functions within a bank.

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 2.

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 3-6 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.

2 PRECONDITIONS FOR EFFECTIVE BANKING SUPERVISION

Banking supervision is only part of wider arrangements that are needed to promote stability in financial markets. 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 (as outlined in this document);

– well-defined rules governing, and adequate supervision of, other financial 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)[5] 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 time frame, and that, in the interim, depositors are protected.

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 banking organisations. 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 organisations 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.

5 As deposit insurance interacts with banking supervision, some basic principles are discussed in Appendix 2.

This standard requires the following components to be in place:

– a clear, achievable and consistent framework of responsibilities and objectives set by legislation 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 (including staffing, funding and technology) to meet the objectives set, provided on terms that do not undermine the autonomy, integrity 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 and independently verify 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.

3 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 banking organisation'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 organisations and the scope of activities governed by licences should be clearly defined. In particular, at a minimum, the activity of taking a proper bank deposit from the public would typically be reserved for institutions that are licensed and subject to supervision as banks. The term "bank" should be clearly defined and the use of the word "bank"[6] 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 should 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

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

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 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 banking organisation'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.

3.1 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[7] 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 should 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 should 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 should 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. 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.

3.2 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 should 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

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

and compliance functions) and that the “four eyes” principle (segregation of various functions, crosschecking, 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.)

3.3 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[8]. 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.

3.4 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 bank will have sufficient capital to support its proposed strategic plan, especially in light of start-up costs and possible operational losses in the early stages. In addition, the licensing authority should assess whether the projections are consistent and realistic, and whether the proposed bank is likely to be viable. In most 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.

3.5 PRIOR APPROVAL FROM THE HOME COUNTRY SUPERVISOR WHEN THE PROPOSED OWNER IS A FOREIGN BANK (SEE ALSO SECTION 6.2)

When a foreign bank, subsidiary of a foreign banking group, or a foreign nonbanking 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[9] 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[10]. 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.

3.6 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.

8 With regard to the “fit and proper” evaluation, where appropriate, differentiation can be made between the supervisory board and the executive board.

9 See “Minimum Standards for the supervision of international banking groups and their cross-border establishments” – Volume III of the Compendium.

10 See “The Supervision of cross-border banking” (Annex B) – Volume III of the Compendium – for guidance on assessing whether a supervisor capably performs such tasks.

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 for ownership or voting control involving established percentages of a bank's outstanding shares.[11] The threshold for approval of significant ownership changes may be higher than that for notification.

3.7 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 banking organisation 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 should 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.

4 ARRANGEMENTS FOR ONGOING BANKING SUPERVISION

4.1 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

11 These established percentages typically range between 5 and 10%

borrower are not always made objectively. Connected parties include a bank's parent organisation, major shareholders, subsidiaries, affiliated entities, 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. 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. Managing this risk is of growing importance in sophisticated financial markets where customers actively manage their interest rate exposure. Special attention should be paid to this risk in countries 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 will turn out 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 market place.

4.2 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 prudent and appropriate minimum capital adequacy requirements for all banks. Such requirements should reflect the risks that the banks undertake, and must define the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, these requirements must not be less than those established in the Basle Capital Accord and its amendments.

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 reduce the risk of loss to depositors, creditors and other stakeholders of the bank and to help supervisors pursue the overall stability of the banking industry. Supervisors must set prudent and appropriate minimum capital adequacy requirements 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. If a bank's ratio falls below the minimum, banking supervisors should ensure that it has realistic plans to restore the minimum in a timely fashion. Supervisors should also consider whether additional restrictions are needed in such cases.

In 1988, the member countries of the Basle Committee on Banking Supervision agreed to a method of ensuring a bank's capital adequacy.[12] 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.

12 See "International convergence of capital measurement and capital standards" – Volume I of the Compendium.

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 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 riskweighted assets.[13] These requirements are applied to banks on a consolidated basis.[14] It must be stressed that these ratios are considered a minimum standard and many supervisors require higher ratios or apply stricter definitions of capital or higher risk weights than set out in the Accord.

2 CREDIT RISK MANAGEMENT

(i) Credit-granting standards and credit monitoring process

Principle 7: An essential part of any supervisory system is the 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 should 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 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 loan loss 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 should require the bank to strengthen its lending practices, credit-granting standards, and overall financial strength.*

13 Although the Accord applies to internationally active banks, many countries also apply the Accord to their domestic banks.

14 Supervisors should, of course, also give consideration to monitoring the capital adequacy of banks on a non-consolidated basis.

When guarantees or collateral are provided, the bank should have a mechanism in place for continually assessing the strength of these guarantees and appraising the worth of the collateral. Supervisors should 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[15]. 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.

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

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 subject to the approval of the bank's board of directors, reported to the supervisors, or prohibited altogether.

Supervising banking organisations on a consolidated basis can in some circumstances identify and 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 appropriate reserves against such risks.[16]

15 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.

16 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.[17] Banking supervisors should also ensure that bank management has set appropriate limits and implemented adequate internal controls for their foreign exchange business.[18]

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[19] 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 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.[20] 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

17 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.

18 See "Supervision of banks' foreign exchange positions" – Volume I of the Compendium.

19 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.

20 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.

scenarios, diversification of funding sources, and contingency planning.[21] 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 should determine that banks have adequate and well-tested business resumption plans for all major systems, with remote site facilities, to protect against such events.

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, assess, manage and control the risks of the business.

There are four 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.);
- the "four eyes" principle (segregation of various functions, cross-checking, dual control of assets, double signatures, etc.); and
- physical control over assets and investments.

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. Consequently, the internal auditor must have an appropriate status within the bank and adequate reporting lines designed to safeguard his or her independence.[22] 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 and that management takes appropriate corrective action in response to internal control weaknesses identified by internal and external auditors.

21 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.

22 In some countries, supervisors recommend that banks establish an "audit committee" within the board of directors. The purpose of this committee is to facilitate the effective performance of board oversight.

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 organisation. 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.[23] Specifically, supervisors should encourage the adoption of those recommendations of the Financial Action Task Force on Money Laundering (FATF) that apply to financial institutions. 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 that are being undertaken or attempted in order to ensure that banks have controls capable of countering them.

4.3 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 group 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 work is carried out by examiners and in others by qualified external auditors. In still other countries, a mixed system of

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

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.

Regardless of their mix of on-site and off-site activities or their use of work done by 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 should 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. Banking supervisors should also make full use of publicly-available information and analysis.

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[24]

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 provisions and 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.

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

The supervisory agency should establish clear internal guidelines related to the frequency and scope of examinations. In addition, examination policies and procedures should 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, the work of external auditors should be utilised 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 the right to veto the appointment of a particular firm of external auditors where supervisory reliance is to be placed on the firm's work. In addition, supervisors should urge banking groups to use common auditors and common accounting dates throughout the group, to the extent possible.

It is also important that the supervisors and external auditors have a clear understanding of their respective roles. Before problems are detected at a bank, the external auditors should clearly understand their responsibilities for communicating with the supervisory agency and should also be protected from personal liability for disclosures, in good faith, of such information. A mechanism should be in place to facilitate discussions between the supervisors and the external auditors.[25] In many instances, these discussions should also include the bank.

In all cases, the supervisory agency should have the legal authority and means to conduct independent checks of banks based on identified concerns.

3 SUPERVISION ON A CONSOLIDATED BASIS

An essential element of banking supervision is the ability of the supervisors to supervise the consolidated banking organisation. This includes the ability to review both banking and non-banking activities conducted by the banking organisation, either directly or indirectly (through subsidiaries and affiliates), and activities conducted at both domestic and foreign offices. Supervisors need to take into account that non-financial activities of a bank or group may pose risks to the bank. Supervisors should decide which prudential requirements will be applied on a bank-only (solo) basis, which ones will be applied on a consolidated basis, and which ones will be applied on both bases. In all cases, the banking supervisors should be aware of the overall structure of the banking organisation or group when applying their supervisory methods.[26] Banking supervisors should also have the ability to coordinate with other authorities responsible for supervising specific entities within the organisation's structure.

4.4 INFORMATION REQUIREMENTS OF BANKING ORGANISATIONS

Principle 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.

For banking supervisors to conduct effective off-site supervision of banks and to evaluate the condition of the local banking market, they must receive financial information at regular intervals and this information must be verified periodically through on-site examinations or external audits.

25 The Basle Committee has reviewed the relationship between bank supervisors and external auditors and has developed best practices for supervisors with regard to their interaction with external auditors. See "The Relationship between bank supervisors and external auditors" – Volume III of the Compendium.

26 The Basle Committee recommended supervision on a consolidated basis in its paper "Consolidated supervision of banks' international activities" – Volume I of the Compendium.

Banking supervisors must ensure that each bank maintains adequate accounting 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. In order that the accounts portray a true and fair view, it is essential that assets are recorded at values that are realistic and consistent, taking account of current values, where relevant, and that profit reflects what, on a net basis, is likely to be received and takes into account likely transfers to loan loss reserves. It is important that banks submit information in a format that makes comparisons among banks possible although, for certain purposes, data derived from internal management information systems may also be helpful to supervisors. At a minimum, periodic reporting should include a bank's balance sheet, contingent liabilities and income statement, with supporting details and key risk exposures.

Supervisors can be obstructed or misled when banks knowingly or recklessly provide false information of material importance to the supervisory process. If a bank provides information to the supervisor knowing that it is materially false or misleading, or it does so recklessly, supervisory and/or criminal action should be taken against both the individuals involved and the institution.

1 ACCOUNTING STANDARDS

In order to ensure that the information submitted by banks is of a comparable nature and its meaning is clear, the supervisory agency will need to provide report instructions that clearly establish the accounting standards to be used in preparing the reports. These standards should be based on accounting principles and rules that command wide international acceptance and be aimed specifically at banking institutions.

2 SCOPE AND FREQUENCY OF REPORTING

The supervisory agency needs to have powers to determine the scope and frequency of reporting to reflect the volatility of the business and to enable the agency to track what is happening at individual banks on both a solo and consolidated basis, as well as with the banking system as a whole. The supervisors should develop a series of informational reports for banks to prepare and submit at regular intervals. While some reports may be filed as often as monthly, others may be filed quarterly or annually. In addition, some reports may 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 reliable data. External auditors should express an opinion on 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 quality of the annual accounts or regulatory reports, or with the work done by external auditors, they should have the ability to use supervisory measures to bring about timely corrective action, and 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 such areas as the loan portfolio, loan loss reserves, nonperforming assets (including the treatment of interest on such assets), asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting. Where it is competent and independent of management, internal audits can be relied upon as a source of information and may 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[27] 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.

5 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 and financial position that is comprehensive and not misleading. This information should be timely and sufficient for market participants to assess the risk inherent in any individual banking organisation.[28]

5 FORMAL POWERS OF SUPERVISORS

Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about timely 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. In extreme circumstances, this should include the ability to revoke the banking licence or recommend its revocation.

5.1 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 timely 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 should have the authority not only to restrict the current activities of the bank but also withhold approval for new activities or acquisitions. They should 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.

27 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.

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

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.

5.2 LIQUIDATION PROCEDURES

In the most extreme cases, and despite ongoing attempts by the supervisors to ensure that a problem situation is resolved, a banking organisation 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 should 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.

6 CROSS-BORDER BANKING

The Principles set out in this section are consistent with the so-called Basle Concordat and its successors.[29] The Concordat establishes understandings relating to contact and collaboration between home and host country authorities in the supervision of banks' cross-border establishments. The most recent of these documents, "The supervision of crossborder banking", was developed by the Basle Committee in collaboration with the Offshore Group of Banking Supervisors and subsequently endorsed by 130 countries attending the International Conference of Banking Supervisors in June 1996. This document contains twenty-nine recommendations aimed at removing obstacles to the implementation of effective consolidated supervision.

6.1 OBLIGATIONS OF HOME COUNTRY SUPERVISORS

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

As part of practising consolidated banking supervision, banking supervisors must adequately monitor and apply appropriate prudential norms to all aspects of the business conducted by their banking organisations worldwide including at their foreign branches, joint ventures and subsidiaries. A major responsibility of the parent bank supervisor is to determine that the parent bank is providing adequate oversight not only of its overseas branches but also its joint ventures and subsidiaries. This parent bank oversight should include 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 should 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

29 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.

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 should 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.

6.2 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 and are therefore important participants 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.

APPENDICES

1 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.[30] 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 should be recognised.

Government-owned commercial banks typically 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 governmentowned commercial banks operate to the same high level of professional skill and disciplines as required of privately-owned commercial banks in order to preserve a strong credit and control culture in the banking system as a whole. In addition, supervisors should apply their supervisory methods in the same manner to government-owned commercial banks as they do to all other commercial banks.

2 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 and are compulsory rather than voluntary.

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 ursues 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.[31]

30 This can include savings banks and cooperative banks. These banks are different, however, from "policy" banks that typically specialise in certain types of lending or target certain sectors of the economy.

31 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.

ANNEX 8

THE BASEL COMMITTEE ON BANKING SUPERVISION: PRINCIPLES FOR THE MANAGEMENT OF CREDIT RISK, SEPTEMBER 2000 BY THE RISK MANAGEMENT GROUP

This annex contains a replication of the above mentioned document by the Basel Committee. The full publication is available free of charge on the Bank for International Settlements' website.

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I INTRODUCTION

1. While financial institutions have faced difficulties over the years for a multitude of reasons, the major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties. This experience is common in both G-10 and non-G-10 countries.

2. Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organisation.

3. For most banks, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including in the banking book and in the trading book, and both on and off the balance sheet. Banks are increasingly facing credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, interbank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transactions.

4. Since exposure to credit risk continues to be the leading source of problems in banks world-wide, banks and their supervisors should be able to draw useful lessons from past experiences. Banks should now have a keen awareness of the need to identify, measure, monitor and control credit risk as well as to determine that they hold adequate capital against these risks and that they are adequately compensated for risks incurred. The Basel Committee is issuing this document in order to encourage banking supervisors globally to promote sound practices for managing credit risk. Although the principles contained in this paper are most clearly applicable to the business of lending, they should be applied to all activities where credit risk is present.

5. The sound practices set out in this document specifically address the following areas: (i) establishing an appropriate credit risk environment; (ii) operating under a sound creditgranting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; and (iv) ensuring adequate controls over credit risk. Although specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities, a comprehensive credit risk management program will address these four areas. These practices should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves, and the disclosure of credit risk, all of which have been addressed in other recent Basel Committee documents.[1]

6. While the exact approach chosen by individual supervisors will depend on a host of factors, including their on-site and off-site supervisory techniques and the degree to which external auditors are also used in the supervisory function, *all members of the Basel Committee agree that the principles set out in this paper should be used in evaluating a bank's credit risk management system.* Supervisory expectations for the credit risk management approach used by individual banks should be commensurate with the scope and sophistication of the bank's activities. For smaller or less sophisticated banks, supervisors need to determine that the credit risk management approach used is sufficient for their activities and that they have instilled sufficient risk-return discipline in their credit risk management processes. The Committee stipulates in Sections II to VI of the paper, principles for banking supervisory authorities to apply in assessing bank's credit risk management systems. In addition, the appendix provides an overview of credit problems commonly seen by supervisors.

1 See in particular *Sound Practices for Loan Accounting and Disclosure* (July 1999) and *Best Practices for Credit Risk Disclosure* (September 2000).

7. A further particular instance of credit risk relates to the process of settling financial transactions. If one side of a transaction is settled but the other fails, a loss may be incurred that is equal to the principal amount of the transaction. Even if one party is simply late in settling, then the other party may incur a loss relating to missed investment opportunities. Settlement risk (i.e. the risk that the completion or settlement of a financial transaction will fail to take place as expected) thus includes elements of liquidity, market, operational and reputational risk as well as credit risk. The level of risk is determined by the particular arrangements for settlement. Factors in such arrangements that have a bearing on credit risk include: the timing of the exchange of value; payment/settlement finality; and the role of intermediaries and clearing houses.[2]

8. This paper was originally published for consultation in July 1999. The Committee is grateful to the central banks, supervisory authorities, banking associations, and institutions that provided comments. These comments have informed the production of this final version of the paper.

PRINCIPLES FOR THE ASSESSMENT OF BANKS' MANAGEMENT OF CREDIT RISK

A. ESTABLISHING AN APPROPRIATE CREDIT RISK ENVIRONMENT

Principle 1: The board of directors should have responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks.

Principle 2: Senior management should have responsibility for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank's activities and at both the individual credit and portfolio levels.

Principle 3: Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that the risks of products and activities new to them are subject to adequate risk management procedures and controls before being introduced or undertaken, and approved in advance by the board of directors or its appropriate committee.

B. OPERATING UNDER A SOUND CREDIT GRANTING PROCESS

Principle 4: Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

Principle 5: Banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in a comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.

Principle 6: Banks should have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.

Principle 7: All extensions of credit must be made on an arm's-length basis. In particular, credits to related companies and individuals must be authorised on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.

C. MAINTAINING AN APPROPRIATE CREDIT ADMINISTRATION, MEASUREMENT AND MONITORING PROCESS

Principle 8: Banks should have in place a system for the ongoing administration of their various credit risk-bearing portfolios.

2 See in particular *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions* (September 2000), in which the annotated bibliography (annex 3) provides a list of publications related to various settlement risks.

Principle 9: Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.

Principle 10: Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities.

Principle 11: Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.

Principle 12: Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.

Principle 13: Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.

D. ENSURING ADEQUATE CONTROLS OVER CREDIT RISK

Principle 14: Banks must establish a system of independent, ongoing assessment of the bank's credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management.

Principle 15: Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.

Principle 16: Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.

E. THE ROLE OF SUPERVISORS

Principle 17: Supervisors should require that banks have an effective system in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. Supervisors should conduct an independent evaluation of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio. Supervisors should consider setting prudential limits to restrict bank exposures to single borrowers or groups of connected counterparties.

II ESTABLISHING AN APPROPRIATE CREDIT RISK ENVIRONMENT

Principle 1: The board of directors should have responsibility for approving and periodically (at least annually) reviewing the credit risk strategy and significant credit risk policies of the bank. The strategy should reflect the bank's tolerance for risk and the level of profitability the bank expects to achieve for incurring various credit risks.

9. As with all other areas of a bank's activities, the board of directors[3] has a critical role to play in overseeing the credit-granting and credit risk management functions of the bank. Each bank should develop a credit risk strategy or plan that establishes the objectives guiding the bank's credit-granting activities and adopt the necessary policies and procedures for conducting such activities. The credit risk strategy, as well as significant credit risk policies, should be approved and periodically (at least annually) reviewed by the board of directors. The board needs to recognise that the strategy and policies must cover the many activities of the bank in which credit exposure is a significant risk.

10. The strategy should include a statement of the bank's willingness to grant credit based on exposure type (for example, commercial, consumer, real estate), economic sector, geographical location, currency, maturity and anticipated profitability. This might also include the identification of target markets and the overall characteristics that the bank would want to achieve in its credit portfolio (including levels of diversification and concentration tolerances).

11. The credit risk strategy should give recognition to the goals of credit quality, earnings and growth. Every bank, regardless of size, is in business to be profitable and, consequently, must determine the acceptable risk/reward trade-off for its activities, factoring in the cost of capital. A bank's board of directors should approve the bank's strategy for selecting risks and maximising profits. The board should periodically review the financial results of the bank and, based on these results, determine if changes need to be made to the strategy. The board must also determine that the bank's capital level is adequate for the risks assumed throughout the entire organisation.

12. The credit risk strategy of any bank should provide continuity in approach. Therefore, the strategy will need to take into account the cyclical aspects of any economy and the resulting shifts in the composition and quality of the overall credit portfolio. Although the strategy should be periodically assessed and amended, it should be viable in the long-run and through various economic cycles.

13. The credit risk strategy and policies should be effectively communicated throughout the banking organisation. All relevant personnel should clearly understand the bank's approach to granting and managing credit and should be held accountable for complying with established policies and procedures.

14. The board should ensure that senior management is fully capable of managing the credit activities conducted by the bank and that such activities are done within the risk strategy, policies and tolerances approved by the board. The board should also regularly (i.e. at least annually), either within the credit risk strategy or within a statement of credit policy, approve the bank's overall credit granting criteria (including general terms and conditions). In addition, it should approve the manner in which the bank will organise its credit-granting functions, including independent review of the credit granting and management function and the overall portfolio.

15. While members of the board of directors, particularly outside directors, can be important sources of new business for the bank, once a potential credit is introduced, the bank's established processes should determine how much and at what terms credit is granted. In order to avoid conflicts of interest, it is important that board members not override the credit-granting and monitoring processes of the bank.

16. The board of directors should ensure that the bank's remuneration policies do not contradict its credit risk strategy. Remuneration policies that reward unacceptable behaviour such as generating short-term profits while deviating from credit policies or exceeding established limits, weaken the bank's credit processes.

3 This paper refers to a management structure composed of a board of directors and senior management. The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the notions of the board of directors and senior management are used in this paper not to identify legal constructs but rather to label two decision-making functions within a bank.

Principle 2: Senior management should have responsibility for implementing the credit risk strategy approved by the board of directors and for developing policies and procedures for identifying, measuring, monitoring and controlling credit risk. Such policies and procedures should address credit risk in all of the bank's activities and at both the individual credit and portfolio levels.

17. Senior management of a bank is responsible for implementing the credit risk strategy approved by the board of directors. This includes ensuring that the bank's credit-granting activities conform to the established strategy, that written procedures are developed and implemented, and that loan approval and review responsibilities are clearly and properly assigned. Senior management must also ensure that there is a periodic independent internal assessment of the bank's credit-granting and management functions.[4]

18. A cornerstone of safe and sound banking is the design and implementation of written policies and procedures related to identifying, measuring, monitoring and controlling credit risk. Credit policies establish the framework for lending and guide the credit-granting activities of the bank. Credit policies should address such topics as target markets, portfolio mix, price and non-price terms, the structure of limits, approval authorities, exception procesing/reporting, etc. Such policies should be clearly defined, consistent with prudent banking practices and relevant regulatory requirements, and adequate for the nature and complexity of the bank's activities. The policies should be designed and implemented within the context of internal and external factors such as the bank's market position, trade area, staff capabilities and technology. Policies and procedures that are properly developed and implemented enable the bank to: (i) maintain sound credit-granting standards; (ii) monitor and control credit risk; (iii) properly evaluate new business opportunities; and (iv) identify and administer problem credits.

19. As discussed further in paragraphs 30 and 37 through 41 below, banks should develop and implement policies and procedures to ensure that the credit portfolio is adequately diversified given the bank's target markets and overall credit strategy. In particular, such policies should establish targets for portfolio mix as well as set exposure limits on single counterparties and groups of connected counterparties, particular industries or economic sectors, geographic regions and specific products. Banks should ensure that their own internal exposure limits comply with any prudential limits or restrictions set by the banking supervisors.

20. In order to be effective, credit policies must be communicated throughout the organisation, implemented through appropriate procedures, monitored and periodically revised to take into account changing internal and external circumstances. They should be applied, where appropriate, on a consolidated bank basis and at the level of individual affiliates. In addition, the policies should address equally the important functions of reviewing credits on an individual basis and ensuring appropriate diversification at the portfolio level.

21. When banks engage in granting credit internationally, they undertake, in addition to standard credit risk, risk associated with conditions in the home country of a foreign borrower or counterparty. Country or sovereign risk encompasses the entire spectrum of risks arising from the economic, political and social environments of a foreign country that may have potential consequences for foreigners' debt and equity investments in that country. Transfer risk focuses more specifically on a borrower's capacity to obtain the foreign exchange necessary to service its cross-border debt and other contractual obligations. In all instances of international transactions, banks need to understand the globalisation of financial markets and the potential for spillover effects from one country to another or contagion effects for an entire region.

22. Banks that engage in granting credit internationally must therefore have adequate policies and procedures for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities. The monitoring of country risk factors should incorporate (i) the potential default of foreign private sector counterparties arising from country-specific economic factors and (ii) the enforceability of loan agreements and the timing and ability to realise collateral under the national legal framework. This function is often the responsibility of a specialist team familiar with the particular issues.

4 This may be difficult for very small banks; however, there should be adequate checks and balances in place to promote sound credit decisions.

Principle 3: Banks should identify and manage credit risk inherent in all products and activities. Banks should ensure that the risks of products and activities new to them are subject to adequate risk management procedures and controls before being introduced or undertaken, and approved in advance by the board of directors or its appropriate committee.

23. The basis for an effective credit risk management process is the identification and analysis of existing and potential risks inherent in any product or activity. Consequently, it is important that banks identify all credit risk inherent in the products they offer and the activities in which they engage. Such identification stems from a careful review of the existing and potential credit risk characteristics of the product or activity.

24. Banks must develop a clear understanding of the credit risks involved in more complex credit-granting activities (for example, loans to certain industry sectors, asset securitisation, customer-written options, credit derivatives, credit-linked notes). This is particularly important because the credit risk involved, while not new to banking, may be less obvious and require more analysis than the risk of more traditional credit-granting activities. Although more complex credit-granting activities may require tailored procedures and controls, the basic principles of credit risk management will still apply.

25. New ventures require significant planning and careful oversight to ensure the risks are appropriately identified and managed. Banks should ensure that the risks of new products and activities are subject to adequate procedures and controls before being introduced or undertaken. Any major new activity should be approved in advance by the board of directors or its appropriate delegated committee.

26. It is critical that senior management determine that the staff involved in any activity where there is borrower or counterparty credit risk, whether established or new, basic or more complex, be fully capable of conducting the activity to the highest standards and in compliance with the bank's policies and procedures.

III.OPERATING UNDER A SOUND CREDIT GRANTING PROCESS

Principle 4: Banks must operate within sound, well-defined credit-granting criteria. These criteria should include a clear indication of the bank's target market and a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.

27. Establishing sound, well-defined credit-granting criteria is essential to approving credit in a safe and sound manner. The criteria should set out who is eligible for credit and for how much, what types of credit are available, and under what terms and conditions the credits should be granted.

28. Banks must receive sufficient information to enable a comprehensive assessment of the true risk profile of the borrower or counterparty. Depending on the type of credit exposure and the nature of the credit relationship to date, the factors to be considered and documented in approving credits include:

- the purpose of the credit and sources of repayment;
- the current risk profile (including the nature and aggregate amounts of risks) of the borrower or counterparty and collateral and its sensitivity to economic and market developments;
- the borrower's repayment history and current capacity to repay, based on historical financial trends and future cash flow projections, under various scenarios;
- for commercial credits, the borrower's business expertise and the status of the borrower's economic sector and its position within that sector;
- the proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower; and

– where applicable, the adequacy and enforceability of collateral or guarantees, including under various scenarios.

In addition, in approving borrowers or counterparties for the first time, consideration should be given to the integrity and reputation of the borrower or counterparty as well as their legal capacity to assume the liability. Once credit-granting criteria have been established, it is essential for the bank to ensure that the information it receives is sufficient to make proper credit-granting decisions. This information will also serve as the basis for rating the credit under the bank's internal rating system.

29. Banks need to understand to whom they are granting credit. Therefore, prior to entering into any new credit relationship, a bank must become familiar with the borrower or counterparty and be confident that they are dealing with an individual or organisation of sound repute and creditworthiness. In particular, strict policies must be in place to avoid association with individuals involved in fraudulent activities and other crimes. This can be achieved through a number of ways, including asking for references from known parties, accessing credit registries, and becoming familiar with individuals responsible for managing a company and checking their personal references and financial condition. However, a bank should not grant credit simply because the borrower or counterparty is familiar to the bank or is perceived to be highly reputable.

30. Banks should have procedures to identify situations where, in considering credits, it is appropriate to classify a group of obligors as connected counterparties and, thus, as a single obligor. This would include aggregating exposures to groups of accounts exhibiting financial interdependence, including corporate or non-corporate, where they are under common ownership or control or with strong connecting links (for example, common management, familial ties).[5] Banks should also have procedures for aggregating exposures to individual clients across business activities.

31. Many banks participate in loan syndications or other such loan consortia. Some institutions place undue reliance on the credit risk analysis done by the lead underwriter or on external commercial loan credit ratings. All syndicate participants should perform their own due diligence, including independent credit risk analysis and review of syndicate terms prior to committing to the syndication. Each bank should analyse the risk and return on syndicated loans in the same manner as directly sourced loans.

32. Granting credit involves accepting risks as well as producing profits. Banks should assess the risk/reward relationship in any credit as well as the overall profitability of the account relationship. In evaluating whether, and on what terms, to grant credit, banks need to assess the risks against expected return, factoring in, to the greatest extent possible, price and non-price (e.g. collateral, restrictive covenants, etc.) terms. In evaluating risk, banks should also assess likely downside scenarios and their possible impact on borrowers or counterparties. A common problem among banks is the tendency not to price a credit or overall relationship properly and therefore not receive adequate compensation for the risks incurred.

33. In considering potential credits, banks must recognise the necessity of establishing provisions for identified and expected losses and holding adequate capital to absorb unexpected losses. The bank should factor these considerations into credit-granting decisions, as well as into the overall portfolio risk management process.[6]

34. Banks can utilise transaction structure, collateral and guarantees to help mitigate risks (both identified and inherent) in individual credits but transactions should be entered into primarily on the strength of the borrower's repayment capacity. Collateral cannot be a substitute for a comprehensive assessment of the borrower or counterparty, nor can it compensate for insufficient information. It should be recognised that any credit enforcement actions (e.g. foreclosure proceedings) can

5 Connected counterparties may be a group of companies related financially or by common ownership, management, research and development, marketing or any combination thereof. Identification of connected counterparties requires a careful analysis of the impact of these factors on the financial interdependency of the parties involved.

6 Guidance on loan classification and provisioning is available in the document *Sound Practices for Loan Accounting and Disclosure* (July 1999).

eliminate the profit margin on the transaction. In addition, banks need to be mindful that the value of collateral may well be impaired by the same factors that have led to the diminished recoverability of the credit. Banks should have policies covering the acceptability of various forms of collateral, procedures for the ongoing valuation of such collateral, and a process to ensure that collateral is, and continues to be, enforceable and realisable. With regard to guarantees, banks should evaluate the level of coverage being provided in relation to the credit-quality and legal capacity of the guarantor. Banks should be careful when making assumptions about implied support from third parties such as the government.

35. Netting agreements are an important way to reduce credit risks, especially in interbank transactions. In order to actually reduce risk, such agreements need to be sound and legally enforceable.[7]

36. Where actual or potential conflicts of interest exist within the bank, internal confidentiality arrangements (e.g. "Chinese walls") should be established to ensure that there is no hindrance to the bank obtaining all relevant information from the borrower.

Principle 5: Banks should establish overall credit limits at the level of individual borrowers and counterparties, and groups of connected counterparties that aggregate in a comparable and meaningful manner different types of exposures, both in the banking and trading book and on and off the balance sheet.

37. An important element of credit risk management is the establishment of exposure limits on single counterparties and groups of connected counterparties. Such limits are frequently based in part on the internal risk rating assigned to the borrower or counterparty, with counterparties assigned better risk ratings having potentially higher exposure limits. Limits should also be established for particular industries or economic sectors, geographic regions and specific products.

38. Exposure limits are needed in all areas of the bank's activities that involve credit risk. These limits help to ensure that the bank's credit-granting activities are adequately diversified. As mentioned earlier, much of the credit exposure faced by some banks comes from activities and instruments in the trading book and off the balance sheet. Limits on such transactions are particularly effective in managing the overall credit risk profile or counterparty risk of a bank. In order to be effective, limits should generally be binding and not driven by customer demand.

39. Effective measures of potential future exposure are essential for the establishment of meaningful limits, placing an upper bound on the overall scale of activity with, and exposure to, a given counterparty, based on a comparable measure of exposure across a bank's various activities (both on and off-balance-sheet).

40. Banks should consider the results of stress testing in the overall limit setting and monitoring process. Such stress testing should take into consideration economic cycles, interest rate and other market movements, and liquidity conditions.

41. Bank's credit limits should recognise and reflect the risks associated with the nearterm liquidation of positions in the event of counterparty default.[8] Where a bank has several transactions with a counterparty, its potential exposure to that counterparty is likely to vary significantly and discontinuously over the maturity over which it is calculated. Potential future exposures should therefore be calculated over multiple time horizons. Limits should also factor in any unsecured exposure in a liquidation scenario.

Principle 6: Banks should have a clearly-established process in place for approving new credits as well as the amendment, renewal and re-financing of existing credits.

42. Many individuals within a bank are involved in the credit-granting process. These include individuals from the business origination function, the credit analysis function and the credit

7 Guidance on netting arrangements is available in the document *Consultative paper on on-balance sheet netting* (April 1998).

8 Guidance is available in the documents *Banks' Interactions with Highly Leveraged Institutions* and *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (January 1999).

approval function. In addition, the same counterparty may be approaching several different areas of the bank for various forms of credit. Banks may choose to assign responsibilities in different ways; however, it is important that the credit granting process coordinate the efforts of all of the various individuals in order to ensure that sound credit decisions are made.

43. In order to maintain a sound credit portfolio, a bank must have an established formal transaction evaluation and approval process for the granting of credits. Approvals should be made in accordance with the bank's written guidelines and granted by the appropriate level of management. There should be a clear audit trail documenting that the approval process was complied with and identifying the individual(s) and/or committee(s) providing input as well as making the credit decision. Banks often benefit from the establishment of specialist credit groups to analyse and approve credits related to significant product lines, types of credit facilities and industrial and geographic sectors. Banks should invest in adequate credit decision resources so that they are able to make sound credit decisions consistent with their credit strategy and meet competitive time, pricing and structuring pressures.

44. Each credit proposal should be subject to careful analysis by a qualified credit analyst with expertise commensurate with the size and complexity of the transaction. An effective evaluation process establishes minimum requirements for the information on which the analysis is to be based. There should be policies in place regarding the information and documentation needed to approve new credits, renew existing credits and/or change the terms and conditions of previously approved credits. The information received will be the basis for any internal evaluation or rating assigned to the credit and its accuracy and adequacy is critical to management making appropriate judgements about the acceptability of the credit.

45. Banks must develop a corps of credit risk officers who have the experience, knowledge and background to exercise prudent judgement in assessing, approving and managing credit risks. A bank's credit-granting approval process should establish accountability for decisions taken and designate who has the absolute authority to approve credits or changes in credit terms. Banks typically utilise a combination of individual signature authority, dual or joint authorities, and a credit approval group or committee, depending upon the size and nature of the credit. Approval authorities should be commensurate with the expertise of the individuals involved.

Principle 7: All extensions of credit must be made on an arm's-length basis. In particular, credits to related companies and individuals must be authorised on an exception basis, monitored with particular care and other appropriate steps taken to control or mitigate the risks of non-arm's length lending.

46. Extensions of credit should be made subject to the criteria and processes described above. These create a system of checks and balances that promote sound credit decisions. Therefore, directors, senior management and other influential parties (e.g. shareholders) should not seek to override the established credit-granting and monitoring processes of the bank.

47. A potential area of abuse arises from granting credit to non-arms-length and related parties, whether companies or individuals.[9] Consequently, it is important that banks grant credit to such parties on an arm's-length basis and that the amount of credit granted is suitably monitored. Such controls are most easily implemented by requiring that the terms and conditions of such credits not be more favourable than credit granted to non-related borrowers under similar circumstances and by imposing strict absolute limits on such credits. Another possible method of control is the public disclosure of the terms of credits granted to related parties. The bank's credit-granting criteria should not be altered to accommodate related companies and individuals.

48. Material transactions with related parties should be subject to the approval of the board of directors (excluding board members with conflicts of interest), and in certain circumstances (e.g. a large loan to a major shareholder) reported to the banking supervisory authorities.

9 Related parties can include the bank's subsidiaries and affiliates, its major shareholders, directors and senior management, and their direct and related interests, as well as any party that the bank exerts control over or that exerts control over the bank.

IV. MAINTAINING AN APPROPRIATE CREDIT ADMINISTRATION, MEASUREMENT AND MONITORING PROCESS

Principle 8: Banks should have in place a system for the ongoing administration of their various credit risk-bearing portfolios.

49. Credit administration is a critical element in maintaining the safety and soundness of a bank. Once a credit is granted, it is the responsibility of the business unit, often in conjunction with a credit administration support team, to ensure that the credit is properly maintained. This includes keeping the credit file up to date, obtaining current financial information, sending out renewal notices and preparing various documents such as loan agreements.

50. Given the wide range of responsibilities of the credit administration function, its organisational structure varies with the size and sophistication of the bank. In larger banks, responsibilities for the various components of credit administration are usually assigned to different departments. In smaller banks, a few individuals might handle several of the functional areas. Where individuals perform such sensitive functions as custody of key documents, wiring out funds, or entering limits into the computer database, they should report to managers who are independent of the business origination and credit approval processes.

51. In developing their credit administration areas, banks should ensure:

- the efficiency and effectiveness of credit administration operations, including monitoring documentation, contractual requirements, legal covenants, collateral, etc.;
- the accuracy and timeliness of information provided to management information systems;
- adequate segregation of duties;
- the adequacy of controls over all "back office" procedures; and
- compliance with prescribed management policies and procedures as well as applicable laws and regulations.

52. For the various components of credit administration to function appropriately, senior management must understand and demonstrate that it recognises the importance of this element of monitoring and controlling credit risk.

53. The credit files should include all of the information necessary to ascertain the current financial condition of the borrower or counterparty as well as sufficient information to track the decisions made and the history of the credit. For example, the credit files should include current financial statements, financial analyses and internal rating documentation, internal memoranda, reference letters, and appraisals. The loan review function should determine that the credit files are complete and that all loan approvals and other necessary documents have been obtained.

Principle 9: Banks must have in place a system for monitoring the condition of individual credits, including determining the adequacy of provisions and reserves.

54. Banks need to develop and implement comprehensive procedures and information systems to monitor the condition of individual credits and single obligors across the bank's various portfolios. These procedures need to define criteria for identifying and reporting potential problem credits and other transactions to ensure that they are subject to more frequent monitoring as well as possible corrective action, classification and/or provisioning.[10]

55. An effective credit monitoring system will include measures to:

- ensure that the bank understands the current financial condition of the borrower or counterparty;
- monitor compliance with existing covenants;

10 See footnote 6.

– assess, where applicable, collateral coverage relative to the obligor's current condition;

– identify contractual payment delinquencies and classify potential problem credits on a timely basis; and

– direct promptly problems for remedial management.

56. Specific individuals should be responsible for monitoring credit quality, including ensuring that relevant information is passed to those responsible for assigning internal risk ratings to the credit. In addition, individuals should be made responsible for monitoring on an ongoing basis any underlying collateral and guarantees. Such monitoring will assist the bank in making necessary changes to contractual arrangements as well as maintaining adequate reserves for credit losses. In assigning these responsibilities, bank management should recognise the potential for conflicts of interest, especially for personnel who are judged and rewarded on such indicators as loan volume, portfolio quality or short-term profitability.

Principle 10: Banks are encouraged to develop and utilise an internal risk rating system in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities.

57. An important tool in monitoring the quality of individual credits, as well as the total portfolio, is the use of an internal risk rating system. A well-structured internal risk rating system is a good means of differentiating the degree of credit risk in the different credit exposures of a bank. This will allow more accurate determination of the overall characteristics of the credit portfolio, concentrations, problem credits, and the adequacy of loan loss reserves. More detailed and sophisticated internal risk rating systems, used primarily at larger banks, can also be used to determine internal capital allocation, pricing of credits, and profitability of transactions and relationships.

58. Typically, an internal risk rating system categorises credits into various classes designed to take into account gradations in risk. Simpler systems might be based on several categories ranging from satisfactory to unsatisfactory; however, more meaningful systems will have numerous gradations for credits considered satisfactory in order to truly differentiate the relative credit risk they pose. In developing their systems, banks must decide whether to rate the riskiness of the borrower or counterparty, the risks associated with a specific transaction, or both.

59. Internal risk ratings are an important tool in monitoring and controlling credit risk. In order to facilitate early identification of changes in risk profiles, the bank's internal risk rating system should be responsive to indicators of potential or actual deterioration in credit risk. Credits with deteriorating ratings should be subject to additional oversight and monitoring, for example, through more frequent visits from credit officers and inclusion on a watchlist that is regularly reviewed by senior management. The internal risk ratings can be used by line management in different departments to track the current characteristics of the credit portfolio and help determine necessary changes to the credit strategy of the bank. Consequently, it is important that the board of directors and senior management also receive periodic reports on the condition of the credit portfolios based on such ratings.

60. The ratings assigned to individual borrowers or counterparties at the time the credit is granted must be reviewed on a periodic basis and individual credits should be assigned a new rating when conditions either improve or deteriorate. Because of the importance of ensuring that internal ratings are consistent and accurately reflect the quality of individual credits, responsibility for setting or confirming such ratings should rest with a credit review function independent of that which originated the credit concerned. It is also important that the consistency and accuracy of ratings is examined periodically by a function such as an independent credit review group.

Principle 11: Banks must have information systems and analytical techniques that enable management to measure the credit risk inherent in all on- and off-balance sheet activities. The management information system should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.

61. Banks should have methodologies that enable them to quantify the risk involved in exposures to individual borrowers or counterparties. Banks should also be able to analyse credit risk at

the product and portfolio level in order to identify any particular sensitivities or concentrations. The measurement of credit risk should take account of (i) the specific nature of the credit (loan, derivative, facility, etc.) and its contractual and financial conditions (maturity, reference rate, etc.); (ii) the exposure profile until maturity in relation to potential market movements; (iii) the existence of collateral or guarantees; and (iv) the potential for default based on the internal risk rating. The analysis of credit risk data should be undertaken at an appropriate frequency with the results reviewed against relevant limits. Banks should use measurement techniques that are appropriate to the complexity and level of the risks involved in their activities, based on robust data, and subject to periodic validation.

62. The effectiveness of a bank's credit risk measurement process is highly dependent on the quality of management information systems. The information generated from such systems enables the board and all levels of management to fulfil their respective oversight roles, including determining the adequate level of capital that the bank should be holding. Therefore, the quality, detail and timeliness of information are critical. In particular, information on the composition and quality of the various portfolios, including on a consolidated bank basis, should permit management to assess quickly and accurately the level of credit risk that the bank has incurred through its various activities and determine whether the bank's performance is meeting the credit risk strategy.

63. Banks should monitor actual exposures against established limits. It is important that banks have a management information system in place to ensure that exposures approaching risk limits are brought to the attention of senior management. All exposures should be included in a risk limit measurement system. The bank's information system should be able to aggregate credit exposures to individual borrowers and counterparties and report on exceptions to credit risk limits on a meaningful and timely basis.

64. Banks should have information systems in place that enable management to identify any concentrations of risk within the credit portfolio. The adequacy of scope of information should be reviewed on a periodic basis by business line managers and senior management to ensure that it is sufficient to the complexity of the business. Increasingly, banks are also designing information systems that permit additional analysis of the credit portfolio, including stress testing.

Principle 12: Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio.

65. Traditionally, banks have focused on oversight of contractual performance of individual credits in managing their overall credit risk. While this focus is important, banks also need to have in place a system for monitoring the overall composition and quality of the various credit portfolios. This system should be consistent with the nature, size and complexity of the bank's portfolios.

66. A continuing source of credit-related problems in banks is concentrations within the credit portfolio. Concentrations of risk can take many forms and can arise whenever a significant number of credits have similar risk characteristics. Concentrations occur when, among other things, a bank's portfolio contains a high level of direct or indirect credits to (i) a single counterparty, (ii) a group of connected counterparties[11], (iii) a particular industry or economic sector, (iv) a geographic region, (v) an individual foreign country or a group of countries whose economies are strongly interrelated, (vi) a type of credit facility, or (vii) a type of collateral. Concentrations also occur in credits with the same maturity. Concentrations can stem from more complex or subtle linkages among credits in the portfolio. The concentration of risk does not only apply to the granting of loans but to the whole range of banking activities that, by their nature, involve counterparty risk. A high level of concentration exposes the bank to adverse changes in the area in which the credits are concentrated.

67. In many instances, due to a bank's trade area, geographic location or lack of access to economically diverse borrowers or counterparties, avoiding or reducing concentrations may be extremely difficult. In addition, banks may want to capitalise on their expertise in a particular industry or economic sector. A bank may also determine that it is being adequately compensated

11 See footnote 5.

for incurring certain concentrations of risk. Consequently, banks should not necessarily forego booking sound credits solely on the basis of concentration. Banks may need to make use of alternatives to reduce or mitigate concentrations. Such measures can include pricing for the additional risk, increased holdings of capital to compensate for the additional risks and making use of loan participations in order to reduce dependency on a particular sector of the economy or group of related borrowers. Banks must be careful not to enter into transactions with borrowers or counterparties they do not know or engage in credit activities they do not fully understand simply for the sake of diversification.

68. Banks have new possibilities to manage credit concentrations and other portfolio issues. These include such mechanisms as loan sales, credit derivatives, securitisation programs and other secondary loan markets. However, mechanisms to deal with portfolio concentration issues involve risks that must also be identified and managed. Consequently, when banks decide to utilise these mechanisms, they need to first have policies and procedures, as well as adequate controls, in place.

Principle 13: Banks should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions.

69. An important element of sound credit risk management involves discussing what could potentially go wrong with individual credits and within the various credit portfolios, and factoring this information into the analysis of the adequacy of capital and provisions. This "what if" exercise can reveal previously undetected areas of potential credit risk exposure for the bank. The linkages between different categories of risk that are likely to emerge in times of crisis should be fully understood. In case of adverse circumstances, there may be a substantial correlation of various risks, especially credit and market risk. Scenario analysis and stress testing are useful ways of assessing areas of potential problems.

70. Stress testing should involve identifying possible events or future changes in economic conditions that could have unfavourable effects on a bank's credit exposures and assessing the bank's ability to withstand such changes. Three areas that banks could usefully examine are: (i) economic or industry downturns; (ii) market-risk events; and (iii) liquidity conditions. Stress testing can range from relatively simple alterations in assumptions about one or more financial, structural or economic variables to the use of highly sophisticated financial models. Typically, the latter are used by large, internationally active banks.

71. Whatever the method of stress testing used, the output of the tests should be reviewed periodically by senior management and appropriate action taken in cases where the results exceed agreed tolerances. The output should also be incorporated into the process for assigning and updating policies and limits.

72. The bank should attempt to identify the types of situations, such as economic downturns, both in the whole economy or in particular sectors, higher than expected levels of delinquencies and defaults, or the combinations of credit and market events, that could produce substantial losses or liquidity problems. Such an analysis should be done on a consolidated bank basis. Stress-test analyses should also include contingency plans regarding actions management might take given certain scenarios. These can include such techniques as hedging against the outcome or reducing the size of the exposure.

V. ENSURING ADEQUATE CONTROLS OVER CREDIT RISK

Principle 14: Banks must establish a system of independent, ongoing assessment of the bank's credit risk management processes and the results of such reviews should be communicated directly to the board of directors and senior management.

73. Because various appointed individuals throughout a bank have the authority to grant credit, the bank should have an efficient internal review and reporting system in order to manage effectively the

bank's various portfolios. This system should provide the board of directors and senior management with sufficient information to evaluate the performance of account officers and the condition of the credit portfolio.

74. Internal credit reviews conducted by individuals independent from the business function provide an important assessment of individual credits and the overall quality of the credit portfolio. Such a credit review function can help evaluate the overall credit administration process, determine the accuracy of internal risk ratings and judge whether the account officer is properly monitoring individual credits. The credit review function should report directly to the board of directors, a committee with audit responsibilities, or senior management without lending authority (e.g., senior management within the risk control function).

Principle 15: Banks must ensure that the credit-granting function is being properly managed and that credit exposures are within levels consistent with prudential standards and internal limits. Banks should establish and enforce internal controls and other practices to ensure that exceptions to policies, procedures and limits are reported in a timely manner to the appropriate level of management for action.

75. The goal of credit risk management is to maintain a bank's credit risk exposure within parameters set by the board of directors and senior management. The establishment and enforcement of internal controls, operating limits and other practices will help ensure that credit risk exposures do not exceed levels acceptable to the individual bank. Such a system will enable bank management to monitor adherence to the established credit risk objectives.

76. Limit systems should ensure that granting of credit exceeding certain predetermined levels receive prompt management attention. An appropriate limit system should assist management in controlling credit risk exposures, initiating discussion about opportunities and risks, and monitoring actual risk taking against predetermined credit risk tolerances.

77. Internal audits of the credit risk processes should be conducted on a periodic basis to determine that credit activities are in compliance with the bank's credit policies and procedures, that credits are authorised within the guidelines established by the bank's board of directors and that the existence, quality and value of individual credits are accurately being reported to senior management. Such audits should also be used to identify areas of weakness in the credit risk management process, policies and procedures as well as any exceptions to policies, procedures and limits.

Principle 16: Banks must have a system in place for early remedial action on deteriorating credits, managing problem credits and similar workout situations.

78. One reason for establishing a systematic credit review process is to identify weakened or problem credits.[12] A reduction in credit quality should be recognised at an early stage when there may be more options available for improving the credit. Banks must have a disciplined and vigorous remedial management process, triggered by specific events, that is administered through the credit administration and problem recognition systems.

79. A bank's credit risk policies should clearly set out how the bank will manage problem credits. Banks differ on the methods and organisation they use to manage problem credits. Responsibility for such credits may be assigned to the originating business function, a specialised workout section, or a combination of the two, depending upon the size and nature of the credit and the reason for its problems.

80. Effective workout programs are critical to managing risk in the portfolio. When a bank has significant credit-related problems, it is important to segregate the workout function from the area that originated the credit. The additional resources, expertise and more concentrated focus of a specialised workout section normally improve collection results. A workout section can help develop an effective strategy to rehabilitate a troubled credit or to increase the amount of repayment ultimately collected. An experienced workout section can also provide valuable input into any credit restructurings organised by the business function.

12 See footnote 6.

VI. THE ROLE OF SUPERVISORS

Principle 17: Supervisors should require that banks have an effective system in place to identify, measure, monitor and control credit risk as part of an overall approach to risk management. Supervisors should conduct an independent evaluation of a bank's strategies, policies, procedures and practices related to the granting of credit and the ongoing management of the portfolio. Supervisors should consider setting prudential limits to restrict bank exposures to single borrowers or groups of connected counterparties.

81. Although the board of directors and senior management bear the ultimate responsibility for an effective system of credit risk management, supervisors should, as part of their ongoing supervisory activities, assess the system in place at individual banks to identify, measure, monitor and control credit risk. This should include an assessment of any measurement tools (such as internal risk ratings and credit risk models) used by the bank. In addition, they should determine that the board of directors effectively oversees the credit risk management process of the bank and that management monitors risk positions, and compliance with and appropriateness of policies.

82. To evaluate the quality of credit risk management systems, supervisors can take a number of approaches. A key element in such an evaluation is the determination by supervisors that the bank is utilising sound asset valuation procedures. Most typically, supervisors, or the external auditors on whose work they partially rely, conduct a review of the quality of a sample of individual credits. In those instances where the supervisory analysis agrees with the internal analysis conducted by the bank, a higher degree of dependence can be placed on the use of such internal reviews for assessing the overall quality of the credit portfolio and the adequacy of provisions and reserves[13]. Supervisors or external auditors should also assess the quality of a bank's own internal validation process where internal risk ratings and/or credit risk models are used. Supervisors should also review the results of any independent internal reviews of the credit-granting and credit administration functions. Supervisors should also make use of any reviews conducted by the bank's external auditors, where available.

83. Supervisors should take particular note of whether bank management recognises problem credits at an early stage and takes the appropriate actions.[14] Supervisors should monitor trends within a bank's overall credit portfolio and discuss with senior management any marked deterioration. Supervisors should also assess whether the capital of the bank, in addition to its provisions and reserves, is adequate related to the level of credit risk identified and inherent in the bank's various on-and off-balance sheet activities.

84. In reviewing the adequacy of the credit risk management process, home country supervisors should also determine that the process is effective across business lines, subsidiaries and national boundaries. It is important that supervisors evaluate the credit risk management system not only at the level of individual businesses or legal entities but also across the wide spectrum of activities and subsidiaries within the consolidated banking organisation.

85. After the credit risk management process is evaluated, the supervisors should address with management any weaknesses detected in the system, excess concentrations, the classification of problem credits and the estimation of any additional provisions and the effect on the bank's profitability of any suspension of interest accruals. In those instances where supervisors determine that a bank's overall credit risk management system is not adequate or effective for that bank's specific credit risk profile, they should ensure the bank takes the appropriate actions to improve promptly its credit risk management process.

13 The New Capital Adequacy Framework anticipates that, subject to supervisory approval, banks' internal rating methodologies may be used as a basis for regulatory capital calculation. Guidance to supervisors specific to this purpose will be published in due course.

14 See footnote 6.

86. Supervisors should consider setting prudential limits (e.g., large exposure limits) that would apply to all banks, irrespective of the quality of their credit risk management process. Such limits would include restricting bank exposures to single borrowers or groups of connected counterparties. Supervisors may also want to impose certain reporting requirements for credits of a particular type or exceeding certain established levels. In particular, special attention needs to be paid to credits granted to counterparties "connected" to the bank, or to each other.

APPENDIX

COMMON SOURCES OF MAJOR CREDIT PROBLEMS

1. Most major banking problems have been either explicitly or indirectly caused by weaknesses in credit risk management. In supervisors' experience, certain key problems tend to recur. Severe credit losses in a banking system usually reflect simultaneous problems in several areas, such as concentrations, failures of due diligence and inadequate monitoring. This appendix summarises some of the most common problems related to the broad areas of concentrations, credit processing, and market- and liquidity-sensitive credit exposures.

CONCENTRATIONS

2. Concentrations are probably the single most important cause of major credit problems. Credit concentrations are viewed as any exposure where the potential losses are large relative to the bank's capital, its total assets or, where adequate measures exist, the bank's overall risk level. Relatively large losses[15] may reflect not only *large exposures,* but also the potential for *unusually high percentage losses given default.*

3. Credit concentrations can further be grouped roughly into two categories:

– *Conventional credit concentrations* would include concentrations of credits to single borrowers or counterparties, a group of connected counterparties, and sectors or industries, such as commercial real estate, and oil and gas.

– *Concentrations based on common or correlated risk factors* reflect subtler or more situation-specific factors, and often can only be uncovered through analysis. Disturbances in Asia and Russia in late 1998 illustrate how close linkages among emerging markets under stress conditions and previously undetected correlations between market and credit risks, as well as between those risks and liquidity risk, can produce widespread losses.

4. Examples of concentrations based on the potential for unusually deep losses often embody factors such as leverage, optionality, correlation of risk factors and structured financings that concentrate risk in certain tranches. For example, a highly leveraged borrower will likely produce larger credit losses for a given severe price or economic shock than a less leveraged borrower whose capital can absorb a significant portion of any loss. The onset of exchange rate devaluations in late 1997 in Asia revealed the correlation between exchange rate devaluation and declines in financial condition of foreign exchange derivative counterparties resident in the devaluing country, producing very substantial losses relative to notional amounts of those derivatives. The risk in a pool of assets can be concentrated in a securitisation into subordinated tranches and claims on leveraged special purpose vehicles, which in a downturn would suffer substantial losses.

5. The recurrent nature of credit concentration problems, especially involving conventional credit concentrations, raises the issue of why banks allow concentrations to develop. First, in developing their business strategy, most banks face an inherent trade-off between choosing to specialise in a few key areas with the goal of achieving a market leadership position and diversifying their income streams, especially when they are engaged in some volatile market segments. This trade-off has been exacerbated by intensified competition among banks and non-banks alike for traditional banking activities, such as providing credit to investment grade corporations. Concentrations appear most

15 Losses are equal to the exposure times the percentage loss given the event of default.

frequently to arise because banks identify "hot" and rapidly growing industries and use overly optimistic assumptions about an industry's future prospects, especially asset appreciation and the potential to earn above-average fees and/or spreads. Banks seem most susceptible to overlooking the dangers in such situations when they are focused on asset growth or market share.

6. Banking supervisors should have specific regulations limiting concentrations to one borrower or set of related borrowers, and, in fact, should also expect banks to set much lower limits on single-obligor exposure. Most credit risk managers in banks also monitor industry concentrations. Many banks are exploring techniques to identify concentrations based on common risk factors or correlations among factors. While small banks may find it difficult not to be at or near limits on concentrations, very large banking organisations must recognise that, because of their large capital base, their exposures to single obligors can reach imprudent levels while remaining within regulatory limits.

CREDIT PROCESS ISSUES

7. Many credit problems reveal basic weaknesses in the credit granting and monitoring processes. While shortcomings in underwriting and management of market-related credit exposures represent important sources of losses at banks, many credit problems would have been avoided or mitigated by a strong internal credit process.

8. Many banks find carrying out *a thorough credit assessment* (or basic due diligence) a substantial challenge. For traditional bank lending, competitive pressures and the growth of loan syndication techniques create time constraints that interfere with basic due diligence. Globalisation of credit markets increases the need for financial information based on sound accounting standards and timely macroeconomic and flow of funds data. When this information is not available or reliable, banks may dispense with financial and economic analysis and support credit decisions with simple indicators of credit quality, especially if they perceive a need to gain a competitive foothold in a rapidly growing foreign market. Finally, banks may need new types of information, such as risk measurements, and more frequent financial information, to assess relatively newer counterparties, such as institutional investors and highly leveraged institutions.

9. The absence of *testing and validation of new lending techniques* is another important problem. Adoption of untested lending techniques in new or innovative areas of the market, especially techniques that dispense with sound principles of due diligence or traditional benchmarks for leverage, have led to serious problems at many banks. Sound practice calls for the application of basic principles to new types of credit activity. Any new technique involves uncertainty about its effectiveness. That uncertainty should be reflected in somewhat greater conservatism and corroborating indicators of credit quality. An example of the problem is the expanded use of credit-scoring models in consumer lending in the United States and some other countries. Large credit losses experienced by some banks for particular tranches of certain mass-marketed products indicates the potential for scoring weaknesses.

10. Some credit problems arise from *subjective decision-making by senior management* of the bank. This includes extending credits to companies they own or with which they are affiliated, to personal friends, to persons with a reputation for financial acumen or to meet a personal agenda, such as cultivating special relationships with celebrities.

11. Many banks that experienced asset quality problems in the 1990s lacked an *effective credit review process* (and indeed, many banks had no credit review function). Credit review at larger banks usually is a department made up of analysts, independent of the lending officers, who make an independent assessment of the quality of a credit or a credit relationship based on documentation such as financial statements, credit analysis provided by the account officer and collateral appraisals. At smaller banks, this function may be more limited and performed by internal or external auditors. The purpose of credit review is to provide appropriate checks and balances to ensure that credits are made in accordance with bank policy and to provide an independent judgement of asset quality, uninfluenced by relationships with the borrower. Effective credit review not only helps to detect

poorly underwritten credits, it also helps prevent weak credits from being granted, since credit officers are likely to be more diligent if they know their work will be subject to review.

12. A common and very important problem among troubled banks in the early 1990s was their failure to *monitor borrowers or collateral values.* Many banks neglected to obtain periodic financial information from borrowers or real estate appraisals in order to evaluate the quality of loans on their books and the adequacy of collateral. As a result, many banks failed to recognise early signs that asset quality was deteriorating and missed opportunities to work with borrowers to stem their financial deterioration and to protect the bank's position. This lack of monitoring led to a costly process by senior management to determine the dimension and severity of the problem loans and resulted in large losses.

13. In some cases, the failure to perform adequate due diligence and financial analysis and to monitor the borrower can result in a breakdown of *controls to detect credit-related fraud.* For example, banks experiencing fraud-related losses have neglected to inspect collateral, such as goods in a warehouse or on a showroom floor, have not authenticated or valued financial assets presented as collateral, or have not required audited financial statements and carefully analysed them. An effective credit review department and independent collateral appraisals are important protective measures, especially to ensure that credit officers and other insiders are not colluding with borrowers.

14. In addition to shortcomings in due diligence and credit analysis, bank credit problems reflect other recurring problems in credit-granting decisions. Some banks analyse credits and decide on appropriate non-price credit terms, but do not use *risk-sensitive pricing.* Banks that lack a sound pricing methodology and the discipline to follow consistently such a methodology will tend to attract a disproportionate share of under-priced risks. These banks will be increasingly disadvantaged relative to banks that have superior pricing skills.

15. Many banks have experienced credit losses because of the failure to use sufficient *caution with certain leveraged credit arrangements.* As noted above, credit extended to highly leveraged borrowers is likely to have large losses in default. Similarly, leveraged structures such as some buyout or debt restructuring strategies, or structures involving customer-written options, generally introduce concentrated credit risks into the bank's credit portfolio and should only be used with financially strong customers. Often, however, such structures are most appealing to weaker borrowers because the financing enables a substantial upside gain if all goes well, while the borrower's losses are limited to its net worth.

16. Many banks' credit activities involve *lending against non-financial assets.* In such lending, many banks have failed to make an adequate assessment of the correlation between the financial condition of the borrower and the price changes and liquidity of the market for the collateral assets. Much asset-based business lending (i.e. commercial finance, equipment leasing, and factoring) and commercial real estate lending appear to involve a relatively high correlation between borrower creditworthiness and asset values. Since the borrower's income, the principal source of repayment, is generally tied to the assets in question, deterioration in the borrower's income stream, if due to industry or regional economic problems, may be accompanied by declines in asset values for the collateral. Some asset based consumer lending (i.e. home equity loans, auto financing) exhibits a similar, if weaker, relationship between the financial health of consumers and the markets for consumer assets.

17. A related problem is that many banks do not take *sufficient account of business cycle effects* in lending. As income prospects and asset values rise in the ascending portion of the business cycle, credit analysis may incorporate overly optimistic assumptions. Industries such as retailing, commercial real estate and real estate investment trusts, utilities, and consumer lending often experience strong cyclical effects. Sometimes the cycle is less related to general business conditions than the product cycle in a relatively new, rapidly growing sector, such as health care and telecommunications. Effective stress testing which takes account of business or product cycle effects is one approach to incorporating into credit decisions a fuller understanding of a borrower's credit risk.

18. More generally, many underwriting problems reflect the absence of a *thoughtful consideration of downside scenarios.* In addition to the business cycle, borrowers may be vulnerable to changes in risk factors such as specific commodity prices, shifts in the competitive landscape and the uncertainty of success in business strategy or management direction. Many lenders fail to "stress test" or analyse the credit using sufficiently adverse assumptions and thus fail to detect vulnerabilities.

MARKET AND LIQUIDITY-SENSITIVE CREDIT EXPOSURES

19. Market and liquidity-sensitive exposures pose special challenges to the credit processes at banks. Market-sensitive exposures include foreign exchange and financial derivative contracts. Liquidity-sensitive exposures include margin and collateral agreements with periodic margin calls, liquidity back-up lines, commitments and some letters of credit, and some unwind provisions of securitisations. The contingent nature of the exposure in these instruments requires the bank to have the ability to assess the probability distribution of the size of actual exposure in the future and its impact on both the borrower's and the bank's leverage and liquidity.

20. An issue faced by virtually all financial institutions is the need to develop *meaningful measures of exposure* that can be compared readily with loans and other credit exposures. This problem is described at some length in the Basel Committee's January 1999 study of exposures to highly leveraged institutions.[16]

21. Market-sensitive instruments require a *careful analysis of the customer's willingness and ability to pay.* Most market-sensitive instruments, such as financial derivatives, are viewed as relatively sophisticated instruments, requiring some effort by both the bank and the customer to ensure that the contract is well understood by the customer. The link to changes in asset prices in financial markets means that the value of such instruments can change very sharply and adversely to the customer, usually with a small, but non-zero probability. Effective stress testing can reveal the potential for large losses, which sound practice suggests should be disclosed to the customer. Banks have suffered significant losses when they have taken insufficient care to ensure that the customer fully understood the transaction at origination and subsequent large adverse price movements left the customer owing the bank a substantial amount.

22. Liquidity-sensitive credit arrangements or instruments require a *careful analysis of the customer's vulnerability to liquidity stresses,* since the bank's funded credit exposure can grow rapidly when customers are subject to such stresses. Such increased pressure to have sufficient liquidity to meet margin agreements supporting over-the-counter trading activities or clearing and settlement arrangements may directly reflect market price volatility. In other instances, liquidity pressures in the financial system may reflect credit concerns and a constricting of normal credit activity, leading borrowers to utilise liquidity backup lines or commitments. Liquidity pressures can also be the result of inadequate liquidity risk management by the customer or a decline in its creditworthiness, making an assessment of a borrower's or counterparty's liquidity risk profile another important element of credit analysis.

23. Market- and liquidity-sensitive instruments change in riskiness with changes in the underlying distribution of price changes and market conditions. For market-sensitive instruments, for example, increases in the volatility of price changes effectively increases potential exposures. Consequently, banks should conduct *stress testing of volatility assumptions.*

24. Market- and liquidity-sensitive exposures, because they are probabilistic, can be correlated with the creditworthiness of the borrower. This is an important insight gained from the market turmoil in Asia, Russia and elsewhere in the course of 1997 and 1998. That is, the same factor that changes the value of a market- or liquidity-sensitive instrument can also influence the borrower's financial health and future prospects. Banks need to *analyse the relationship between market- and liquidity-sensitive exposures and the default risk of the borrower.* Stress testing – shocking the market or liquidity factors – is a key element of that analysis.

16 See *Banks' Interactions with Highly Leveraged Institutions* and *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* (January 1999).

ANNEX 9

THE TACIS PROJECT – CENTRAL BANK TRAINING III

This annex describes the initiation of the TACIS Project – Central Bank Training III (the TACIS Project) and the purpose and content of the training programme.

The contract for the TACIS Project, Central Bank Training III, was signed in Moscow on 13 October 2003 by Richard Wright, Head of the Delegation of the European Commission to Russia, and Willem Duisenberg, President of the ECB on behalf of the ECB and the Eurosystem partners in the project. At a press conference on the same day, Messrs Wright, Duisenberg and Bank of Russia Chairman Sergey M. Ignatiev signed a three-party protocol confirming the profound commitment of all three institutions to cooperate closely in the implementation of the project.

The wider objective of the project, which lasted from 1 November 2003 to 31 October 2005, was to enhance the stability of the Russian banking system by training Bank of Russia supervision staff, thereby assisting the Bank of Russia in more efficiently performing its role and responsibilities in the banking sector. The project also comprised a human resources component aimed at improving the Bank of Russia's human resources development strategy.

The training programme was designed to offer general and specialised training to roughly 800 Bank of Russia supervisors through the medium of one-week courses. In addition, the project included high-level seminars in Moscow for high-ranking Bank of Russia managers and Russian officials, as well as study visits for managers in the supervisory departments to a European banking supervisor/central bank. This book is also a product of the TACIS project, as described in the Introduction.

The training courses covered issues that were identified as particularly relevant to the Bank of Russia during the first three months of the project. Courses gave examples of EU experience and practices in supervision. However, speakers from the EU did not suggest or recommend specific policies or practices to be pursued by the Bank of Russia. Rather, they focused on sharing insight into practices applied by EU banking supervisors in conformity with internationally accepted supervisory principles. A distinct focus during training was on practices used by European banking supervisors to make supervision more forward looking and modern. In this sense, the training programme contributed to the Bank of Russia's wish one day to supplement checks on banks' compliance with existing regulations with risk-based supervision, as described in Chapter 2 of this book.

ONE-WEEK TRAINING COURSES

Training courses usually lasted one week. The overwhelming number of participants was drawn from the Bank of Russia's regional branches. Material used during training courses typically consisted of a set of PowerPoint presentations specially developed for the TACIS project by the ECB's partner institutions.[1] Exercises, cases studies and additional reading material (such as the Basel Comittee's Core Principles for Effective Banking Supervision and the EU Consolidated Banking Directive) were also used during courses.

The course programme consisted of 33 fundamental banking supervision courses providing an overview of supervision practices in similar fashion to this book, and was targeted at participants who share a similar profile with the proposed readers of this book (see Introduction). The course material designed for these courses formed the starting point for the development of this book.

1 The Banca d'Italia, Banco de España, Banco de Portugal, Banque de France, Central Bank and Financial Services Authority of Ireland, De Nederlandsche Bank, Deutsche Bundesbank, the Financial Services Authority, Finansinspektionen, Oesterreichische Nationalbank, Rahoitustarkastus and Suomen Pankki.

These fundamental courses were supplemented by ten types of specialised courses, offered 31 times in total over the period. Two of these specialised courses were for human resources staff (not supervisory staff). An overview of the different courses and the responsible partner in each case is provided in table A9.1.

ONE-DAY HIGH-LEVEL SEMINARS

Four high-level seminars were held in Moscow during the project. Each seminar lasted one day, and all were characterised by a stimulating, policy-oriented dialogue between high-level EU speakers and a Russian audience that included representatives from the Bank of Russia Board and senior management in banking supervision, the Russian legislative branches, the Presidential Administration, the Finance Ministry, Russian academia and the Association of Russian Banks. The four seminars addressed financial stability, Basel II, anti-money laundering as well as corporate governance and operational risk.

A technical seminar for Bank of Russia managers working with their Supervisory Risk Assessment Systems (or Early Warning Systems, as they are commonly known) was also held in Moscow during the project. Participants exchanged information on the Russian system and systems from three EU countries.

STUDY VISITS TO EU SUPERVISORS

A total of eight study visits carried out during the programme allowed Bank of Russia supervisors to visit an EU supervisor/central bank and to examine closely the organisation of supervision and how supervisory principles are translated into daily working routines. Most Bank of Russia participants were head office supervisory managers. The programmes for these visits varied, and included emphases on the whole supervisory process, inspections, off-site supervision, licensing/regulation and financial stability.

Table A9.1 Courses under the TACIS project

	Number of courses	Partner responsible
Courses for all supervisory staff		
Fundamental course	14	Deutsche Bundesbank
Fundamental course	4	Oesterreichische Nationalbank
Fundamental course	6	De Nederlandsche Bank
Fundamental course	2	Banque de France
Fundamental course	3	Rahoitustarkastus, Finland
Fundamental course	2	Finansinspektionen, Sweden
Fundamental course	2	Central Bank and Financial Services Authority of Ireland
Courses for licensing and bank rehabilitation staff		
Licensing	4	Banco de España
Bank rehabilitation	2	Banca d'Italia
Courses for off-site monitoring staff		
Early warning systems	2	Banque de France
Macro monitoring and stress-testing	2	European Central Bank and Suomen Pankki
Credit, country and transfer risk	7	Banca d'Italia
Market, liquidity and operational risk	2	Financial Services Authority, United Kingdom
Courses for on-site inspection staff		
Credit risk/credit portfolio inspection	3	Banco de Portugal
Operational and market risk inspection	3	Banque de France
Business evolution, internal policies/control	4	Banque de France
Courses for HR staff		
HR management and development	2	Deutsche Bundesbank
Total number of courses	64	

SOLUTIONS TO ANNEX I

PROFITABILITY EXERCISE

Interest margin to operating income

This financial soundness indicator is a measure of the relative share of net interest earnings within gross income. (Net interest income/operating income)

Year	2001	2002
Net interest income	15,352	11,103
Operating income	16,854	12,394
Net interest income to operating income (%)	**91.1**	**89.6**

ROA – Return on assets

ROA is a key ratio of profitability, indicating how efficiently a financial institution's assets are employed. (Profit for the financial year after tax/average total assets)

Year	2001	2002
Profit for the financial year	5,298	127
Total assets at the beginning of the year	394,347	436,086
Total assets at the end of the year	436,086	578,655
ROA (%)	**1.28**	**0.03**

Note: The average of total assets should be calculated using the amounts at the beginning and at the end of the year.

ROE – Return on equity

ROE is another key profitability ratio measuring how well shareholders' equity is being used. (Profit for the financial year after tax/average total shareholders' equity)

Year	2001	2002
Profit for the financial year	5,298	127
Total shareholders' equity at the beginning of the year	30,621	32,151
Total shareholders' equity at the end of the year	32,151	31,930
ROE (%)	**16.9**	**0.4**

Note: The average of shareholders' equity should be calculated using the amounts at the beginning and at the end of the year.

Cost/income ratio

The cost/income ratio measures a bank's efficiency. (Total operating expenses/total operating income)

Year	2001	2002
Total operating expenses	8,696	11,416
Total operating income	16,854	12,394
Cost/income ratio (%)	**51,6**	**92,1**

Share of extraordinary profit

This ratio shows how important extraordinary items are for the bank in the reporting year, bearing in mind that such items are non-recurring (extraordinary), and may therefore potentially have a material effect on net income in a reporting period. (Extraordinary profits/ operating profit after extraordinary items but before tax)

Year	**2001**	**2002**
Extraordinary profit	255	1,300
Operating profit before tax	7,947	191
Share of extraordinary profit (%)	**3.2**	**680.6**

Dividends paid to shareholders in percent of net profit

The ratio highlights whether shareholders are being paid at the expense of the bank's financial consolidation. This occurs when the ratio is above 100%. (Dividends paid to shareholders/net profit for the financial year after tax)

Year	**2001**	**2002**
Dividends paid to shareholders	3,580	849
Net profit for the financial year	5,298	127
Dividends paid to shareholders in percent of net profit	**67.6**	**666.7**

CAPITAL ADEQUACY EXERCISE

Capital adequacy ratios		
Item		**2000**
TIER 1		
Capital		16,500
Reserves		13,800
Unallocated profits		321
TIER 2		
Subordinated debt	max 50% Tier1	0
Revaluation reserves		0
CAPITAL BASE		**30,621**
	Risk Weight	**2000**
Loans and advances to credit institutions:		
– current account	20	4,218
– loans	100	13,936
Loans and advances to non-financial enterprises and households:		
– short and long-term loans	100	191,556
– mortgage loans	50	107,922
– non-performing loans	100	4,177
Securities	100	19,243
Intangible, tangible and other assets	100	18,474
Off-balance sheet items:		
– commitments	100	16,415
– guarantees	50	13,472
– documentary credits	20	7,500
Risk Weighted Assets (RWA)		
Capital requirement for banking portfolio	8% of RWA	
Capital adequacy		

		2001		2002	
		16,500		16,500	
		14,580		14,580	
		816		250	
		0		500	
		255		600	
		32,151		**32,430**	
	Weighted	**2001**	**Weighted**	**2002**	**Weighted**
	844	3,634	727	2,294	459
	13,936	16,299	16,299	12,635	12,635
	191,556	183,069	183,069	224,082	224,082
	53,961	151,316	75,658	186,450	93,225
	4,177	17,623	17,623	74,736	74,736
	19,243	20,334	20,334	18,900	18,900
	18,474	28,392	28,392	51,572	51,572
	16,415	25,674	25,674	42,500	42,500
	6,736	20,736	10,368	25,600	12,800
	1,500	9,700	1,940	11,300	2,260
	326,842	sum(d18:d29)	380,084		533,169
	26,147	d31*0,08	30,407		42,654
	9.37	c15/(d32/8)	8.46		6.08

ASSET QUALITY EXERCISE

Non-performing loans/Total loans

The ratio identifies any problems with asset quality in the loan portfolio.

Year	2000	2001	2002
Non-performing loans	8,947	17,623	74,736
Total loans	303,655	346,797	476,418
Non-performing loans/Total loans (%)	**2.95**	**5.08**	**15.69**

Loan provisions/Non-performing loans

Provisions against losses on loans for this ratio are defined as specific provisions, which are the stock of provisions/reserves held by the bank against losses on individual loans (including a collectively assessed group of loans). The ratio of such provisions to non-performing loans indicates how well covered the bank is against losses on non-performing loans as well as the adequacy of the provisioning policy.

Year	2000	2001	2002
Loan provisions	4,770	5,211	8,850
Non-performing loans	8,947	17,623	74,736
Ratio of loan provisions	**53.31**	**29.57**	**11.84**

Non-performing loans net of provisions in relation to net interest income, reserves and shareholders' equity

This ratio compares non-performing loans net of provisions to net interest income, reserves and to total shareholders' equity. The ratio identifies how well the bank is able to cover losses through income, reserves or total shareholders' equity, taking as a starting point the fact that the bank would lose 100% on non-performing loans. In this context, the ratio is calculated by first deducting specific provisions from non-performing loans.

Year	2000	2001	2002
Non-performing loans net of provisions	4,177	12,412	65,886
Net interest income	xxx	15,352	11,103
Comparison 1 (%)		**80.85**	**593.41**
Reserves	13,800	14,580	14,580
Comparison 2 (%)	**30.27**	**85.13**	**451.89**
Total shareholders‘ equity	30,621	32,151	31,930
Comparison 3 (%)	**13.64**	**38.61**	**206.35**

Change in the non-performing loan portfolio

This ratio compares the current non-performing loan portfolio with the non-performing loan portfolio in the previous year, and thereby describes any change in the quality of the loan portfolio.

Year	2000	2001	2002
Non-performing loans in previous year	xxx	8,947	17,623
Non-performing loans in current year	8,947	17,623	74,736
Change in non-performing loan portfolio		**196.97**	**424.08**

Change in Loan Portfolio Index

This ratio compares the loan portfolio in the current year with the loan portfolio in the previous year and describes the tendency in the portfolio's development.

Year	2000	2001	2002
Loans and advances in previous year	xxx	303,655	346,797
Loans and advances in current year	303,655	346,797	476,418
Change in Loan Portfolio Index		**114.21**	**137.38**

FOREIGN EXCHANGE RISK EXERCISE I

Foreign currency-denominated assets to total assets

Measures the relative size of foreign currency assets within total assets.

Year	2000	2001	2002
Total foreign currency assets	29,852	42,510	54,723
Total assets	394,347	436,086	578,655
Foreign currency-denominated assets to total assets	**7.57**	**9.75**	**9.46**

Foreign currency-denominated liabilities to total liabilities

Measures the relative importance of foreign currency funding within total liabilities.

Year	2000	2001	2002
Foreign currency funding/liabilities	24,871	26,386	25,777
Total liabilities (excluding shareholders' equity)	363,726	403,935	546,725
Foreign currency-denominated liabilities to total liabilities	**6.84**	**6.53**	**4.71**

FOREIGN EXCHANGE RISK EXERCISE 2

Assessments as at 31 December 2002		
Item/Currency		**All FX Currency**
Cash		241
Loans and advances to credit institutions: current accounts		1,694
Loans and advances to credit institutions: loans		416
Loans and advances to non-financial enterprises and households: short-term loans		15,993
Loans and advances to non-financial enterprises and households: long-term loans		5,322
Loans and advances to non-financial enterprises and households: mortgage loans		22,668
Net non-performing loans		1,218
Securities: corporate bonds		1,200
Securities: shares		3,150
Other assets: accrued income		1,197
Other assets: accounts receivable		1,624
Total foreign currency assets		**54,723**
Amounts owed to credit institutions: current accounts		9,274
Amounts owed to credit institutions: loans		1,675
Amounts owed to non-financial enterprises and households: sight deposits		0,478
Amounts owed to non-financial enterprises and households: term deposits		4,025
Other liabilities: accrued expenses		47
Other liabilities: accounts receivable		278
Total foreign currency liabilities		**25,777**
Exchange rate (per 1 unit of foreign currency)		x
Exercise 1		
Net currency position	long-short	**28,946**
		54,723-25,777=28,946
Exercise 2		
Capital base		
32,430	Tier1+Tier2	
Net position compared with the capital base (%)	limit 15%	
Overall open position (abbreviated method)		**29,879**
max ((suma (all net long); suma (all net short))		92.1
Exercise 3		
Change in exchange rate (per 1 unit of foreign currency)		
Impact of exchange rate change on bank's income	Value of assets	
	Value of liabilities	
	New net position	
	Profit	
	Total impact on profit	

USD	GBP	EUR	JPY	CHF
144	0	81	16	0
1,016	84	169	101	324
0	0	0	416	0
11,994	2,558	879	0	562
2,128	638	1,703	0	853
4,760	14,054	453	680	2,721
584	243	73	36	282
900	300	0	0	0
1,008	913	630	315	284
598	359	119	35	86
730	535	97	24	238
23,862	**19,684**	**4,204**	**1,623**	**5,350**
2,782	3,709	1,391	463	929
0	0	0	1,675	0
1,571	6,286	2,095	209	317
2,535	442	483	161	404
6	13	13	4	11
66	75	55	44	38
6,960	**10,525**	**4,037**	**2,556**	**1,699**
30	50	32	0,3	20
16,902	**9,159**	**167**	**-933**	**3,651**
Long	Long	Long	Short	Long
over limit	over limit	under limit	under limit	under limit
52.1	**28.2**	**0.5**	**-2.9**	**11.3**

16902/32430*100=52,12

limit 40% of capital base 16902+9159+167+3651

overall position in percent of capital base => over 40 % limit

USD	GBP	EUR	JPY	CHF
27	51	33	0.29	21
21,476	20,078	4,335	1,569	5,618
6,264	10,736	4,163	2,471	1,784
15,212	9,342	172	-902	3,834
-1,690	183	5	31	183
-1,288				

CONCLUSIONS REGARDING THE ANALYSIS OF THE HYPOTHETICAL BANK

Based on an analysis of the balance sheet and profit and loss statement of the hypothetical bank, readers should complete the exercises on profitability, capital adequacy, asset quality and foreign exchange risk. The reader should reach conclusions along the following lines.

Overall, the hypothetical bank is currently operating in a stable, well-established environment. However, during the period for which financial data are available, it appears that the economic condition of the hypothetical bank has deteriorated significantly. It cannot be ruled out that some creative accounting has been used to boost financial statements, which would indicate that the actual financial condition of the bank may be worse than the financial statements suggest. The bank may for example have invented a revaluation of real estate to avoid posting a loss in 2002.

1. PROFITABILITY

Profitability ratios assess the ability of a firm to earn profit. Declining earnings and profitability may for example be signs of weak management or of excessive risk-taking.

a. The hypothetical bank is clearly expanding its lending to non-financial enterprises and households, funding part of this growth via borrowing from credit institutions (i.e. other banks) and the central bank. This strategy has not however generated well-needed profits for the bank, as shown in the decline in net interest income. One reason is that the hypothetical bank has had to turn to costly sources by borrowing from other credit institutions and from the central bank. The interest margin to operating income shows that the bank is extremely reliant on interest income.

b. The bank's operating profit for 2002 shows a loss of 1,101. However, a revaluation of buildings from 2,805 in 2001 to 3,570 has contributed to extraordinary profits of 1,300, which miraculously turns the operating loss into a profit of 191. The bank pays taxes of 64, making the operating profit in 2002 stand at 127. These developments should alert the supervisor to take a closer look at the financial statements, as they may have been manipulated to show a profit.

c. *ROA – Return on assets:* The hypothetical bank shows a substantial deterioration in profitability, with the ROA ratio falling from 1.28% in 2001 to 0.03% in 2002. In other words, the bank is not able to employ assets efficiently.

d. *ROE – Return on equity:* ROE fell from 16.9% in 2001 to 0.4% in 2002. This is an indication of very low profitability, whereby shareholders are not getting a sufficient return on investment. For the hypothetical bank, the low ROE clearly stems from the low profits after tax. The ratio should, however, in general be interpreted with some degree of caution, as a high ratio can indicate both high profitability as well as low capitalisation. Similarly, a low ratio can mean both low profitability as well as high capitalisation.

e. *Cost-to-income ratio:* The cost-to-income ratio increased significantly from 51.6% in 2001 to 92.1% in 2002, indicating a strain on the hypothetical bank's resources. Such a level of costs to income suggests that the bank will either have to increase income or start to trim costs, the latter primarily represented by staff and other administrative costs.

f. *Share of extraordinary profit*: Due to a sharp drop in operating profit before tax (down from 7,947 in 2001 to 191 in 2002), coupled with a simultaneous sharp increase in extraordinary income, the share of extraordinary profit increased over the same period from 3.2% to the extravagant figure of 681%. This unmistakably shows that the hypothetical bank's net result in 2002 relied heavily on extraordinary profit, a situation which cannot be expected to reoccur in the next reporting period.

g. *Dividends paid to shareholders in percent of net profits for the financial year:* The shareholders' dividends increased from 68% in 2001 to 667% in 2002. Taking the hypothetical bank's rather strained financial situation into consideration, paying out such large dividends would at best seem irresponsible and may be an indication that the bank's shareholders are taking what they can before the bank's actual financial situation becomes known and the bank possibly fails.

2. CAPITAL ADEQUACY

Capital adequacy and the availability of free capital determine how robust financial institutions' balance sheets are to shocks. Capital adequacy is thus considered one of the main indicators in assessing the degree of a bank's financial fragility. An adverse trend in aggregate risk-based capital ratios, i.e. the ratio of capital to risk-adjusted assets, may signal increased risk exposure and possible capital adequacy problems.

a. At year-end 2002, the bank is unable to comply with the minimum capital adequacy ratio of 8%. Capital adequacy has deteriorated from 9.37% in 2000 to 8.46% in 2001 and again to 6.08% in 2002.

b. Risk Weighted Assets (RWA) increased over the whole reporting period, notably by 40% in the period 2001-2002. The most striking increases are in non-performing loans, intangible, tangible and other assets and in commitments. For the bank to have remained compliant with minimum capital requirements, available capital should have been 42,654, compared with the actual figure of 32,430 that the bank reported at the end of 2002.

c. As the bank is operating in a stable, well-established environment, it should comply with the capital adequacy ratio as defined by the Basel Committee on Banking Supervision. Although the bank complied with capital adequacy requirements at the end of 2001, the drop from 9.37% in 2000 to 8.46% in 2001 should have alerted the supervisor to possible problems, as the bank was quickly approaching the minimum required level. From a regulatory perspective, inadequate capital reflects financial distress that may lead to bank failure. Regulators' ability to predict capital deficiency by for example scenario analysis or stress-testing would thus greatly enhance the effectiveness of the supervisory process, thereby affording regulators additional time to monitor closely potential problem banks, as well as to impose sanctions (on dividend payments, asset growth, new business activities, salaries, deposit rates, etc.) with the purpose of facilitating institutional recovery.

3. ASSET QUALITY

In general, credit risk has traditionally been the main cause of bank problems. Changes in credit risk are typically assessed by looking at the quality of assets. The quality of a financial institution's loan portfolio depends on loan diversification, repayment performance and the capacity to pay, and currency composition. The credit portfolio is also directly dependent upon the financial health and profitability of the institutions' borrowers, especially the non-financial enterprise sector. Lack of diversification in the loan portfolio can, for example, signal vulnerabilities in the financial system. Loan concentration in a specific economic sector or activity (measured as a share of total loans) makes banks vulnerable to adverse developments in that sector or activity, which is particularly true for exposures to the real estate sector. The following points should be noted:

a. Loans and advances to the public increased by nearly 60% during the three year period 2000-2002 (14.2% in 2001 and 37.4% in 2002).

b. Due to this rapid credit expansion to the public, the supervisor should consider reviewing the bank's policies and internal guidelines on for example credit-granting standards, connected lending, credit concentrations and large exposures.

c. *The ratio for non-performing loans to total loans* increased from 3% at end-2000 to 15.7% at end-2002, implying that the risk in the loan portfolio has increased substantially. This ratio is often used as a proxy for credit quality, as non-performing loans are a result of either poor loan decisions or deteriorating economic conditions impacting on the borrower's ability to meet obligations. Although the ratio is primarily a backward-looking indicator, it can be important by signalling the current health of a bank (and more broadly, the banking sector as a whole).

d. *Loan loss provisions/non-performing loans:* Reserve adequacy in a bank can provide a notion of a bank's capacity to withstand stress. This ratio has dropped from around 53% to just 12% in a few years. This can indicate one of two things: either the bank is very efficient in provisioning (meaning that they know very well how large a portion of the loan that they ultimately will lose

and how much they will recover), or that the bank cannot afford to maintain a high provisioning level without suffering substantial losses. In this case, the bank appears highly under-provisioned, which entails a large risk component.

e. *Non-performing loans net of provisions in relation to net interest income, reserves and shareholders' equity*: These ratios have deteriorated significantly, indicating that more than 100% of net income, reserves and shareholders' equity would be absorbed if all non-performing loans needed to be totally provisioned for (or if they all were to result in an immediate loss).

4. FOREIGN EXCHANGE RATE RISK

a. Exposures to foreign exchange (FX) risk increased during the period 2000-2002, as shown in the ratio of foreign currency-denominated assets to total assets. At the same time, the bank's funding is increasingly in domestic currency.

b. The hypothetical bank appears to have large open positions in USD and GBP in particular, which may indicate that the bank has poor FX risk management and/or is hoping to make quick profits. Both points entail high risks and potentially large losses, and the supervisor might wish to obtain additional information from the bank on its FX policy and risk management principles.

5. SUPERVISORY ACTION PLAN

a. An on-site inspection of the bank is needed and should be commenced within the next day or two.

b. As the main source of the hypothetical bank's problems seem to be located in its loan portfolio, supervisory efforts should be accordingly focused on this area. In particular, the on-site supervisor will need to focus on non-performing loans in order to assess the whether additional provisions are needed and if so, which amount. The on-site supervisor will also need to focus on loans that are still considered as current by the bank, to ensure that they are adequately classified and, if necessary, reclassified as substandard or non-performing. The on-site inspectors should also identify non-performing loans that have been rolled-over or "evergreened" as new current loans. "Evergreening" may indicate insolvency.

c. The evaluation of bank policies, practices and procedures and a bank's adherence to them, together with adequate management information systems, should also be assessed in ensuring that there is adequate internal oversight of domestic lending in foreign currency. Fundamental to the success of a bank's domestic lending in foreign currency is the strength of its respective management information systems and risk management systems.

d. An action plan is needed immediately in relation to making the bank compliant with the minimum capital requirements.

6. ASSESSMENT OF SUPERVISORY EFFORTS

a. The case shows that the hypothetical bank was already heading into trouble in 2001, which suggests that the supervisor should have paid additional attention to the developing problems at this stage, provided that the supervisor's mandate allows it to act proactively (and beyond focusing purely on compliance).

b. The bank is obviously engaged in risky lending and is currently pursuing a rapid credit expansion, as shown by the sharp increase in non-performing loans together with under-provisioning, and the deterioration of the capital ratios.

ANNEX 11

ANSWERS TO ANNEX 2

CHAPTER 1 – BANKING RISK

ANSWER TO QUESTION 1.1.

The correct answers are (a), (b) and (c). A share does not have a repayment schedule, so that it does not carry credit risk. An option is not an asset and is therefore not a correct answer, although the market value of an option can carry credit risk and, under some accounting standards, can be booked on-balance. The head office owned by the bank has no counterpart on which there could be a credit risk.

ANSWER TO QUESTION 1.2.

The correct answers are (a), (d) and (g). Securing a loan through collateral does not mean that the bank should not assess the creditworthiness of the customer. Credit risk remains a major cause of bank failures also in G-10 countries.

ANSWER TO QUESTION 1.3.

The correct answers are (b), (c) and (d). A loan is not a traded instrument and carries no market risk. The head office building owned by the bank is a fixed asset and therefore carries no market risk in the traditional sense of it arising from movements in market prices.

ANSWER TO QUESTION 1.4.

The correct answers are (b), (c) and (e). Banks should indeed have timely information about financial markets in order to manage market risks. Market risks are not the major cause of serious banking problems in G-10 countries. The identification, measurement, management and control of market risks are equally important in G-10 and non-G-10 countries.

ANSWER TO QUESTION 1.5.

The correct answer is (f). All the other instruments mentioned carry interest rate risk because they have a repayment pattern that should be mapped into the maturity ladder.

ANSWER TO QUESTION 1.6.

The correct answers are (c), (d) and (e). Liquidity risk is not subject to a specific capital charge, and banking supervisors in the European Union do not have a common framework for liquidity risk, although they build on common elements.

ANSWER TO QUESTION 1.7.

It should be noted that the reader was asked to identify statements that did not represent typical operation risk events. The correct answers are (c) and (e). The outflow of deposits caused by negative information about a bank impacting on a bank's reputation is not included in operational risk. The damage of a customer's collateral increases the credit risk if the customer defaults on payments, but there is at present no direct damage to the bank's assets.

ANSWER TO QUESTION 1.8.

The correct answer is (b). The standardised approach divides the bank's activities into eight areas with different beta factors, which are used as the basis for calculation of the capital requirement.

ANSWER TO QUESTION 1.9.

The correct answer is (d). Legal services do not belong to eight business areas for which there is a capital charge for operational risk.

CHAPTER 2 – REGULATING AND SUPERVISING BANKS

ANSWER TO QUESTION 2.1.

The correct answer is (b). The protection of banks or financial institutions is not part of the goal of banking supervision. Nor is it a goal to provide financial support.

ANSWER TO QUESTION 2.2.

The correct answer is (b). Not all countries in the EU have supervisory authorities vested with the responsibility for banking supervision and banking supervision is not a European responsibility allocated to a single institution.

ANSWER TO QUESTION 2.3.

The correct answer is (a). The national banking law is usually passed by the national parliament and the banking supervisor monitors banks – not the banking regulator.

ANSWER TO QUESTION 2.4.

The correct answer is (d).

ANSWER TO QUESTION 2.5.

The correct answer is (d). There are no specific principles on capital adequacy requirements incorporated in the Core Principles. The capital adequacy requirements are part of the Basel I and Basel II frameworks.

ANSWER TO QUESTION 2.6.

The correct answer is (b).

ANSWER TO QUESTION 2.7.

The correct answers are (a) and (b). The identification, measurement, management and control of risks are important processes in banks for the supervisor under the risk-based supervisory approach. Quality of risk managers and reporting of risks are also important, but are more relevant as the second layer. Quality of risk managers is not a "process".

CHAPTER 3 – LICENSING OF BANKS

ANSWER TO QUESTION 3.1.

The correct answers are (a) and (d). Shareholder support should be long-term (more than one year) and the shareholder structure should be transparent and never complex.

ANSWER TO QUESTION 3.2.

The correct answers are (b) and (c). The bank's management should assess the market need for the bank, not the supervisor.

ANSWER TO QUESTION 3.3.

The correct answers are (a) and (c). The supervisor shall continue to monitor the issues in point (a) but point (b) should be addressed going forward – it would be wrong to forget about issues examined in the licensing process.

CHAPTER 4 – OFF-SITE AND ON-SITE BANKING SUPERVISION

ANSWER TO QUESTION 4.1.

The correct answers are (a) and (c). Off-site supervision also performs the peer group analysis, prioritisation of resources (perhaps together with on-site supervision) and takes action – not on-site

supervision. For urgent on-site inspections to be effective, the bank should be advised of them in advance of the arrival of the inspection team.

ANSWER TO QUESTION 4.2.

The correct answers are (a) and (b). When off-site supervision applies the more sophisticated models for analysis of banks the supervisor aims to predict the probability that a bank will fail in the future and thereby the ongoing performance of the bank is also scrutinised. They also assess compliance with quantitative standards, whereas assessment of past performance is not an aim but certainly provides information that is useful for predictions.

ANSWER TO QUESTION 4.3.

The correct answers are (a), (b), (c), (e) and (f). Strong external auditing is not part of the bank's (internal) risk management process.

ANSWER TO QUESTION 4.4.

The correct answer is (c).

ANSWER TO QUESTION 4.5.

The correct answer is (c).

ANSWER TO QUESTION 4.6.

The correct answers are (b) and (d). The framework does not aim to lower capital requirements but to achieve a closer alignment of risks and capital requirements. There is no empirical evidence showing that capital requirements in Basel I were too high. The framework aims at formalising the supervisory review process because Basel II allows banks to use internal rating systems (and not risk management and the estimation of provisions against loan losses) as the basis for capital requirements.

CHAPTER 5 – CRISIS MANAGEMENT AND BANK REHABILITATION

ANSWER TO QUESTION 5.1.

The correct answer is (b).

ANSWER TO QUESTION 5.2.

The correct answers are (a) and (d).

ANSWER TO QUESTION 5.3.

The correct answers are (a), (c), (e) and (f). Protecting supervisors against public or private interference in the implementation of their mandate is part of the Core Principles in relation to independence of the supervisory function.

ANSWER TO QUESTION 5.4.

The answer to this question in reality depends on the national legislation in EU countries, but considering the content of this book, the correct answers are (c) and (d). Deposit insurance systems cannot prevent a crisis from occurring. It is not the role of deposit insurance systems to acquire banks and run them, irrespective of how efficiently they might do this.

CHAPTER 6 – MONEY LAUNDERING PREVENTION

ANSWER TO QUESTION 6.1.

The correct answer is (b).

ANSWER TO QUESTION 6.2.

The correct answer is (d). The best way that banks can protect themselves is by focusing on the identification of suspicious customers and transactions.

ANSWER TO QUESTION 6.3.

The correct answer is (a). The key words are "reasonable suspicion".

ANSWER TO QUESTION 6.4.

The correct answer is (b).

CHAPTER 7 – FINANCIAL STABILITY MONITORING

ANSWER TO QUESTION 7.1.

The correct answer is (c). Individual bank failures can be a problem from a banking supervision perspective, but if the failure does not jeopardise the stability of the whole financial system, it is not a good definition of financial stability (and it is not the definition in this book). Financial stability involves more than just the stability of the banking system.

ANSWER TO QUESTION 7.2.

The correct answer is (b). The framework for financial stability analysis and monitoring is being developed, but a single framework did not exist when this book was published.

ANSWER TO QUESTION 7.3.

All four answers are correct.