

Considerations in Achieving Strong Systems of Regulation and Supervision

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1. Introduction

Asia Pacific economies are very diverse in terms of the size, complexity and stage of development of their financial systems. While there are some advanced economies in Asia, such as Japan, South Korea, Hong Kong SAR and Singapore, most of the region consists of emerging market economies (“EMEs”). One common feature of Asia Pacific economies is that their banking systems play an important role in facilitating sustainable economic growth.

Access to capital markets to finance business activity is generally available only to larger, well-established companies with a track record of stable financial performance. Small and medium-sized enterprises (“SMEs”), fledgling entrepreneurs, and consumers rely significantly on banks and non-bank lenders, such as finance companies, to obtain credit.² SMEs are a major contributor to GDP in EMEs. Therefore, to achieve sustainable economic growth and development, it is important that banking systems be comprised of sound, stable, and resilient banks positioned to meet the productive credit needs of their customers.

A sound banking system is one where problems are manageable and, while there might be some bank failures, they are not large or systemic,³ and their overall impact is small. Effective bank regulation and supervision are key factors in maintaining banking system soundness and avoiding, dampening or mitigating future periods of financial instability or crisis.

This article describes fundamental considerations in establishing effective bank regulatory and supervision programs, including lessons learned from past crises. The author also informs the reader of publicly-available resources that provide independent assessments of the quality of jurisdictions’ regulatory and supervisory capabilities. These assessments are conducted by independent multinational authorities such as the International Monetary Fund, the World Bank, and the Bank for International Settlements.

2. Financial Stability, Systemic Risk and Banking System “Safety Nets”

The concept of financial stability does not have a universally accepted definition. One description of financial stability that captures common elements cited by many observers is:

“...a condition where (a jurisdiction’s) financial system – comprising institutions, markets and infrastructure – is able to: allocate savings to investment opportunities efficiently; ensure the rapid settlement of payments; effectively manage potential risks that may harm its performance; and absorb shocks without impairing its operations.”⁴

Responsibility for promoting financial stability is frequently an explicit central bank (“CB”) legal mandate. However, one or more other domestic authorities may also be involved, including:

- Non-CB bank supervisors and regulators;
- Financial market regulators;
- Deposit insurers; and
- Finance ministries.

These same authorities usually also comprise a jurisdiction’s banking system “safety net”, which consists of national authorities who have differing legal mandates, but work together to ensure banking system stability during times of stress or crisis:

- CBs may have direct responsibility for the chartering/licensing, regulation and supervision of banks. If they find a bank is in an unsafe or unsound condition, usually due to capital insufficiency, they may revoke a bank’s license to do business. Under their “lender of last resort” function, CBs have discretionary authority to provide short-term loans to banks to assist them in a temporary liquidity emergency;
- Non-CB bank regulators: primary responsibility for the licensing, regulation and supervision of banks resides in a non-CB authority in some Asian jurisdictions (China, Japan, Indonesia, South Korea and Chinese Taipei);
- Financial market regulators are typically charged with maintaining fair and orderly financial markets (such as stock and commodities exchanges) and may oversee exchange-traded companies’ financial reporting;
- Deposit insurers (“DIs”) promote public confidence in a banking system by protecting the safety of depositors’ funds in the event of bank failures. They also are frequently responsible for arranging orderly resolutions of failing banks. They may provide conditional, short-term financial assistance to banks. Some DIs may have secondary bank examination authority and/or a role in bank license/charter⁵ revocations;

- Finance Ministries are mainly involved in providing government funds (i.e., taxpayers' funds) when crises pose systemic risk and governmental intervention is deemed warranted to preserve public confidence in the banking system.

A 2001 Group of Ten report describes “systemic financial risk” as:

“...the risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy.”⁶

Individual banks can also pose risks to jurisdictions' financial stability – these are referred to as “systemically important financial institutions” or “SIFIs” – if they encounter financial difficulties severe enough to threaten their viability or solvency. Their failure could have “knock on” effects that could adversely impact other banks and companies, or even the entire financial system, which could trigger a financial crisis.

3. Overview of the Banking Business

➤ *Credit intermediation*

Banks' specific business models vary; however, their primary business activity is making loans which are funded by accepting deposits from individuals and corporations – referred to as banks' credit intermediation function. Banks are chartered and licensed by governmental authorities based, in large measure, on their commitment to provide reliable access to credit products and other essential financial services in their local communities.

A banking license confers special benefits such as the ability to accept insured deposits, the safety of which is typically backed by a governmentally-sponsored deposit insurance scheme. Retail bank depositors are concerned with the safety and accessibility of their money, which may include their life's savings. Therefore, they are strongly inclined to do business with banking institutions whose deposits are fully or partially guaranteed in the event of a bank's failure. This customer preference provides banks with a stable source of lower cost funds which they use to make loans.

➤ *Effective corporate governance: the first “line of defense” in protecting bank soundness*

Why do some banks succeed while others underperform or encounter problems that can jeopardize their stability or even viability? Banks' corporate governance, risk management capabilities and risk culture are the main differentiating factors in bank performance and soundness. For this reason, bank supervisors focus on these areas during bank examinations.

Corporate governance has various definitions. The Organization for Economic Co-operation and Development (“OECD”) describes corporate governance as “the structure through which the objectives of (a) company are set, and the means of attaining those objectives and monitoring performance are determined.”⁷

Banks typically operate in a highly competitive environment, competing for business with other banks and non-bank financial services providers. Banks’ ability to identify, measure, evaluate, monitor, control and price risk is critical to achieving their strategic objectives and maximizing financial performance in a safe and sound manner.

An active, interested and vigilant bank board of directors serves as an effective “check and balance” on excessive risk taking, and monitoring the performance of a bank’s senior executive management. Members of a bank’s board of directors have individual and collective legal duties, referred to as their fiduciary responsibilities, to oversee the way a bank’s business is conducted. These duties typically include:

- Appointing competent senior executive management and monitoring their performance
- Establishing the bank’s strategic direction and risk tolerance
- Ensuring that the bank’s capital structure provides adequate protection for depositors and other creditors
- Monitoring enterprise-wide risk on a continuing basis
- Periodically reviewing and approving risk control policies
- Understanding regulators’ views of the bank’s practices and condition
- Remediating regulatory concerns on a timely basis.

Banks especially need to have a comprehensive risk management process, with effective Board and senior management oversight, that identifies, measures, evaluates, monitors, controls and reports all material bank risks on a timely basis.

4. The Nature of Bank Regulation and Supervision

Bank regulation and supervision are closely related and are frequently the responsibility of the same national authority. While the terms “regulation” and “supervision” tend to be used interchangeably, they are not the same.

➤ *Bank regulation*

Bank regulation encompasses the body of laws, rules and implementing regulations specifying minimum licensing and operational requirements to ensure prudent operation and proper conduct of business. Prudential laws, rules and regulations impose restrictions and limitations on banks’ business activities designed to ensure that they operate in a safe and sound manner and maintain a safe and sound

condition – for example, regulations on banks' minimum capital requirements. Banks are also typically subject to laws, rules and regulations on how they conduct business, including consumer protection obligations.

Bank regulators/supervisors also issue regulatory guidance to explain or clarify regulatory/supervisory expectations as to how banks should comply with specific laws, rules, and regulations.

➤ *Bank supervision*

Bank supervision encompasses both prudential supervision, sometimes referred to as micro-prudential supervision, and macro prudential supervision. Prudential supervision has historically focused on assessing individual banks' safety and soundness, primarily through on-site bank examinations.

Macroprudential supervision refers to the imposition of banking rules, regulations or policies intended to control risk to the banking system more broadly. Examples are bank minimum capital requirements and limits on the amount banks can lend in relation to the value of various types of loan collateral, such as a maximum loan-to-value for loans secured by residential real estate.

➤ *Bank examinations and the bank supervision process*

Bank examination and supervision is a critical part of maintaining public confidence in a banking system. Bank examiners, who may also be referred to as bank regulators or bank supervisors,⁸ are highly trained professionals who assess banks' practices and conditions through on-site examinations and inspections on a periodic basis, typically at least annually.

Bank examinations are not the same as financial statement audits; they are qualitative in nature. Bank examiners seek to evaluate whether a bank's current financial condition, banking practices and risk management capabilities are sound, and that the bank has the strength and resiliency to withstand the on-set of less favorable economic conditions without a material weakening of its overall financial position. Accountants and auditors primarily render opinions on whether a company's financial statements fairly present the financial position of a firm as of a specific financial statement date.

Bank supervisors usually meet with a bank's senior executive management and/or board of directors after an examination to present examination findings. When unsatisfactory practices or conditions or violations of laws or regulations are disclosed, bank supervisors obtain commitments from bank management to remedy concerns within agreed-upon timeframes.

When bank examinations disclose excessive risk or unsafe or unsound banking practices or conditions,⁹ bank supervisors require that a bank's board of directors and senior executive management take timely corrective action to mitigate concerns. Regulators usually have legal authority to compel corrective action if voluntary efforts are either not forthcoming or ineffective, or if matters of concern are deemed to pose a future threat to a bank's viability.

➤ *Off-site surveillance*

On-site bank supervision activities are supplemented by off-site surveillance of banks' financial performance. Required bank submissions of certified monthly or quarterly financial data is analyzed, including key financial ratios and performance, to detect potential anomalies in time series data or in comparison to peer group data.

Off-site surveillance is a useful tool in detecting "red flags" and "outliers" in prioritizing finite examiner resources. However, it is not a substitute for on-site examinations or inspections conducted at reasonable intervals by experienced professionals, with an appropriate level of transaction testing.¹⁰ This is primarily due to the potential for inaccuracy or bias in self-reported data that has not been independently verified.

➤ *Regulatory arrangements*

The structure of banking system regulatory oversight and supervision is a public policy determination based on national circumstances and preferences, and varies throughout Asia. Supervisory oversight is usually conducted within the central bank and occasionally by an independent governmental entity.

Jurisdictions adjust and evolve their systems of bank regulation and supervision based on their experiences over time, especially lessons learned from adverse events or periods of financial instability or crisis. The United Kingdom has had an interesting experience in this regard. After the 1995 collapse of Barings Bank related to debilitating losses due to unauthorized securities trading at its Singapore office, prudential bank supervision was shifted from the Bank of England to the U.K. Financial Services Authority (U.K. FSA) in 1997. After perceived regulatory shortcomings related to the Great Financial Crisis of 2007-2008 ("GFC" or the "Crisis"), the U.K. FSA was dissolved and bank supervision was shifted to the Prudential Regulatory Authority of the Bank of England in 2013.

Of the twenty SEACEN member central banks and monetary authorities, sixteen have legal authority giving them primary responsibility for supervising their jurisdiction's banking systems. In four SEACEN jurisdictions,¹¹ a separate non-central bank authority has primary responsibility for bank supervision.

➤ *Macroprudential supervision*

The historical focus of banking system stability monitoring on individual institution risk may not detect the build-up of macroeconomic risks and vulnerabilities that can adversely affect many financial institutions simultaneously. Financial institutions that appear sound can be adversely impacted by common behavior and mutual interaction. For example, asset price bubbles may arise in certain asset classes in an economy – such as commercial and residential real estate – that serve as collateral for bank loans. Sharp price declines in these asset classes could have a destabilizing effect on many banks simultaneously.

Macroprudential supervision refers to the control of banking system risk through the imposition of policies, usually in the form of banking rules and regulations, limiting certain activities, with the intent of controlling risk to the system.

Timely identification of emerging macroeconomic risks and imbalances can serve as the basis to activate macroprudential policy measures, alone or in concert with other policy actions, to avert, dampen or mitigate periods of instability or crisis. Macroprudential surveillance is undertaken by national authorities, usually central banks, to detect and control risks that may adversely affect the financial performance and stability of the banking industry more broadly.

Responsibility for implementing macroprudential measures may reside in different national authorities, and not necessarily be a central bank mandate. Policy actions necessitate close cooperation and coordination among domestic authorities to ensure they do not have contradictory goals or offset each other. Monetary, fiscal and tax policies can also influence systemic risk.

Asian jurisdictions' use of macroprudential policy measures in the recent past has primarily focused on controlling systemic risks arising from rapid rises in real estate values and significant expansion of household debt, the latter fuelled in some cases by credit card lending with lax underwriting criteria.

5. Lessons Learned from Prior Banking Crises and Periods of Financial Instability

There have been many episodes of financial instability in recent decades, including systemic banking crises. Laeven and Valencia (2012) produced a database of “all systemic banking, currency, and sovereign debt crises during the period 1970 – 2011.” Using their crisis definition, they identified 147 banking crises during that period.¹² These crisis events mostly involved individual countries, though many had cross-border spillover effects. These episodes of instability and crisis, and the displacements they caused, typically resulted in large direct costs from governmental interventions to contain the crises. Lengthy post-crisis recovery periods also resulted in substantial economic output losses.

The GFC, which was centered in the U.S. and Eurozone, was the most significant period of global financial instability since the Great Depression. Pre-Crisis, many countries most directly and substantially affected by the GFC had developed what were reputed to be sophisticated monitoring systems to track financial system stability. Yet, those systems and attendant analytical methods almost universally failed to predict the onset, severity and spillover effects of the GFC. Many financial stability assessments published by those jurisdictions reflected no material systemic risk concerns prior to crisis onset.

One of the triggers for the GFC was the sudden cessation of interbank lending among large global banks. This required central banks, regulators and governmental officials to act very quickly, often with less than complete information, to prevent systemic domestic and cross-border events, which could have had even more extreme financial stability implications. Some interventions proved to be quite controversial due to the moral hazard¹³ they posed and, in some cases, taxpayers' funds were put at substantial risk.

➤ *Primary causes of the GFC from a prudential supervisory perspective*

According to analyses of the GFC by the Basel Committee, the Financial Stability Board, the IMF and other industry experts, the most significant underlying causal factors related to regulation and supervision are:

- Failure to conduct regular on-site supervisory inspections or examinations at reasonable intervals and in sufficient depth.
- Failure to identify ineffective bank risk management methods and governance structures, as well as other shortcomings in bank risk cultures.
- Overemphasizing institutions' historic operating results and static financial conditions in assessing risk, not fully considering potential vulnerabilities.
- Allowing banks to operate with excessive leverage.
- Overreliance on off-site surveillance systems to either detect or timely identify "red flags" and emerging risks.
- Failure to understand the risks and policy implications of new bank products and services, and changing bank business models.

➤ *The Asian Financial Crisis of 1997-1998 ("AFC")*

Asia has avoided a significant cross-border financial/banking crisis since the AFC. The AFC was noteworthy for its rapid onset and contagion effects. That crisis spread quickly to other countries due to many cross-border inter-linkages that served as transmission channels for spreading contagion.

Post-AFC reform measures, central bank policy actions and effective financial institution supervision have been effective in controlling financial stability risks over the last two decades. The GFC impacted the region; however, the effects were manageable.

Since the AFC, there has been an increase in the number of large, complex banking conglomerates operating in the region. Some of these conglomerates operate systemically important banks in more than one jurisdiction. Timely and effective regulatory examinations and information-sharing is essential to understanding the risks in these entities and controlling cross-border spillovers, contagion effects and regulatory arbitrage.

6. Cross-Border Banking Conglomerates and Consolidated Supervision

The structures of companies providing banking and other financial services continue to evolve as they seek to expand their geographic reach, and achieve economies of scale and scope as restrictions on banks' affiliations and permissible activities are relaxed or removed in many countries.

Banks' corporate structures may be relatively simple – for example, a stand-alone bank – or complex, such as membership in a diversified corporate conglomerate involved in various businesses, not all of which relate to banking and financial services.

Complex structures may be driven by legitimate business reasons such as legal or tax considerations. It is important for a bank supervisor to understand the business reason(s) behind the chosen corporate architecture and whether the chosen corporate structure can be adequately supervised.

Many banks in Asia operate as part of complex group structures or conglomerates. There may be multiple organizational layers between a bank and its ultimate parent. Non-bank affiliates may also be engaged in activities closely related to banking or financial services, and may engage in business transactions with each other. Some countries allow banks to be part of mixed groups, in which banks are affiliated with, or owned by commercial businesses engaged in activities that are unrelated to the banking business.

Banks are increasingly owned by holding companies or other parent companies that operate in multiple countries. The size and geographic reach of some financial conglomerates and/or their interlinkages may make them systemically important in multiple jurisdictions, thus practicing effective consolidated supervision is essential in promoting financial stability.

Complex structures of financial conglomerates pose several challenges to bank supervisors. First, complex ownership structures, lack of access to information, or other opacities can impair supervisors' ability to assess risk in a financial conglomerate. Second, transactions with affiliates, or problems in affiliated organizations, can adversely impact banks' safety and soundness. Third, contagion risk¹⁴ can spread quickly through a group via intercompany transactions. Fourth, problems in large conglomerates and mixed groups could pose financial stability risks to the countries in which they operate.

Consolidated supervision is a long-standing, fundamental principle and essential element of effective bank supervision, which seeks to determine the financial soundness of a bank, considering the financial soundness and risks posed by affiliate relationships. The Basel Committee on Banking Supervision's "Core principles for banking supervision" ("BCP"), discussed later, stipulate that bank supervisors should have "... the necessary powers, authority and resources to perform comprehensive group-wide supervision of financial conglomerates...(and) ensure financial conglomerates have robust governance, capital, liquidity and risk management frameworks."¹⁵ Moreover, 2012 revisions to the BCP require that banking supervisors should be able to supervise banking groups on a consolidated and on-going basis.

Asia Pacific countries are both home and host supervisors for large, geographically dispersed banking organizations that are part of financial conglomerates operating across the region. Also, global banking organizations operate extensive regional banking networks. Countries' effective implementation of consolidated supervision is, therefore, an important part of promoting regional financial stability.

7. Achieving Effective Bank Regulation and Supervision

Bank supervision is an inherently judgmental process. For supervision to be effective, it must be performed by qualified professionals in a manner that allows for timely detection and mitigation of excessive risk. In addition to a high degree of technical competency, bank supervisors need to possess good judgment, a healthy degree of professional skepticism, and the ability to communicate effectively and persuasively with banks' senior executive managements and boards of directors.

Effective cooperation and information sharing arrangements among domestic and foreign supervisors are essential to understanding and overseeing risk in more complex banking organizations, such as those with multi-tiered corporate structures, mixed (banking and commercial) groups, and cross-border operations. Supervisors who lack the legal authority to share confidential information will likely be unable to adequately assess prudential risks, and thus unable to properly fulfill their supervisory responsibilities.

Bank supervisors need have appropriate legal authority related to safety and soundness oversight of the banking sector and take timely action to identify and mitigate excessive risk or unsound conditions or practices. The GFC exposed instances where bank supervisors were slow in exercising supervisory powers in developing problem situations, allowing problems to worsen. In addition, regulatory interventions in the case of weak or failing banks were sometimes too slow, or the legal authority to intervene (such as prompt corrective action¹⁶) was not stringent enough, allowing nonviable banks to continue operating, increasing ultimate resolution costs. Bank supervisors also need to fulfill their responsibilities free of undue political pressure or interference that can undermine their independence.

Reduced profit margins in traditional bank products have induced banks to develop new products and engage in nontraditional lines of business. Technology can increase the speed of transactions and changes in banks' risk profiles, and can facilitate contagion risk. Greater interconnectedness and cross-border activities and affiliations of banks can increase risk and opportunities for regulatory arbitrage.

Focusing on banks' risk management capabilities and corporate governance during examinations provides insight as to whether their policies and practices provide sufficient "checks and balances" or need to be modified.

Screening out outliers and timely detection of "red flags" is key to proactive bank supervision and preventing the build-up of problems that could possibly pose systemic risk. Supervisory thematic reviews, on-line, real time risk monitoring systems, multilateral supervisory discussions of emerging issues and timely information-sharing for cross-border banking organizations, along with other measures, can assist prudential supervisors in detecting and addressing incipient problems.

8. International Standards for Bank Regulation and Supervision

The Bank for International Settlements, Basel, Switzerland ("BIS"), owned by the world's central banks and monetary authorities,¹⁷ hosts various standard-setting committees that prescribe minimum regulatory and supervisory standards for the international financial services industry. The oldest of these committees is the Basel Committee on Banking Supervision ("BCBS" or the "Basel Committee"),¹⁸ which covers the banking industry.

The BCBS promotes good and sound bank supervisory practices and standards, focused mainly on internationally-active banks.

While the Basel Committee has no supranational authority, member jurisdictions usually adopt agreed-upon standards, sometimes for all their banks.

Harmonization of supervisory practices and regulatory requirements helps to avoid "regulatory arbitrage" which refers to conscious and deliberate strategies by banks to evade or circumvent legal requirements, or take advantage of less stringent (or no) legal requirements, or perceived less stringent supervision, or even the absence of supervisory oversight of certain activities. This can occur, for example, by conducting business in jurisdictions where regulation and supervision of banks is less developed or less stringent.

➤ *International standards for effective bank supervisory programs*

The Basel Committee has done important work in identifying the essential preconditions necessary for regulatory jurisdictions to establish effective bank supervision programs through the development and evolution of “Core Principles for Effective Supervision” (known as the “Basel Core Principles” or “BCP”).

The BCP were originally issued in 1997, and revised in 2006 and 2012. The current version of the BCP states that “The revised Core Principles will continue to provide a comprehensive standard for establishing a sound foundation for the regulation, supervision, governance and risk management of the banking sector.”¹⁹

The 2012 BCP revisions contain 29 core principles (“CPs”), summarized below in Table 1, which incorporate lessons learned from the GFC. Each CP is intended to apply to the prudential supervision of all banks, ranging from large, complex internationally-active banks to small, non-complex deposit-taking institutions. The BCP recognize that supervisory resources should be allocated in proportion to the risk profile and systemic importance of banks.

Assessment criteria have been identified for each of the CPs, designated as either “Essential Criteria” (“minimum baseline requirements for sound supervisory practices universally applicable to all countries”) or “Additional Criteria” (“supervisory practices that exceed current baseline expectations but will contribute to the robustness of individual supervisory frameworks”).

The International Monetary Fund (“IMF”) and World Bank use the BCP to assess the effectiveness of jurisdictions’ supervisory regimes during their Financial Sector Assessment Program (“FSAP”) reviews. FSAP teams assess countries’ compliance with the BCP to determine whether a jurisdiction possesses the necessary pre-conditions to support an effective program of bank supervision. However, an important caveat is in order. While supervisory approaches and practices may appear to be effective, the ultimate test of effectiveness is whether they work in practice. Do they reliably allow for the timely detection and curtailment of unsound practices and excessive bank or industry risk-taking at their incipient stages?

Table 1
Summary of the 29 Basel Core Principles

Principle 1 – Responsibilities, objectives and powers	An effective system of banking supervision has clear responsibilities and objectives for each authority involved in the supervision of banks and banking groups. A suitable legal framework for banking supervision is in place to provide each responsible authority with the necessary legal powers to authorize banks, conduct ongoing supervision, address compliance with laws and undertake timely corrective actions to address safety and soundness concerns.
Principle 2 – Independence, accountability, resourcing and legal protection for supervisors	The supervisor possesses operational independence, transparent processes, sound governance, budgetary processes that do not undermine autonomy and adequate resources, and is accountable for the discharge of its duties and use of its resources. The legal framework for banking supervision includes legal protection for the supervisor.
Principle 3 – Cooperation and collaboration	Cooperation and collaboration: Laws, regulations or other arrangements provide a framework for cooperation and collaboration with relevant domestic authorities and foreign supervisors. These arrangements reflect the need to protect confidential information.
Principle 4 – Permissible activities	The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined and the use of the word “bank” in names is controlled.
Principle 5 – Licensing criteria	The licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance (including the fitness and propriety of Board members and senior management) of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition (including capital base). Where the proposed owner or parent organization is a foreign bank, the prior consent of its home supervisor is obtained.
Principle 6 – Transfer of significant ownership	The supervisor has the power to review, reject and impose prudential conditions on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

Principle 7 – Major acquisitions	The supervisor has the power to approve or reject (or recommend to the responsible authority the approval or rejection of), and impose prudential conditions on, major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and to determine that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.
Principle 8 – Supervisory approach	An effective system of banking supervision requires the supervisor to develop and maintain a forward-looking assessment of the risk profile of individual banks and banking groups, proportionate to their systemic importance; identify, assess and address risks emanating from banks and the banking system as a whole; have a framework in place for early intervention; and have plans in place, in partnership with other relevant authorities, to take action to resolve banks in an orderly manner if they become non-viable.
Principle 9 – Supervisory techniques and tools	Supervisory techniques and tools: The supervisor uses an appropriate range of techniques and tools to implement the supervisory approach and deploys supervisory resources on a proportionate basis, taking into account the risk profile and systemic importance of banks.
Principle 10 – Supervisory reporting	The supervisor collects, reviews and analyses prudential reports and statistical returns from banks on both a solo and a consolidated basis, and independently verifies these reports through either on-site examinations or use of external experts.
Principle 11 – Corrective and sanctioning powers of supervisors	The supervisor acts at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system. The supervisor has at its disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability to revoke the banking license or to recommend its revocation.
Principle 12 – Consolidated supervision	An essential element of banking supervision is that the supervisor supervises the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential standards to all aspects of the business conducted by the banking group worldwide.
Principle 13 – Home-host relationships	Home and host supervisors of cross border banking groups share information and cooperate for effective supervision of the group and group entities, and effective handling of crisis situations. Supervisors require the local operations of foreign banks to be conducted to the same standards as those required of domestic banks.

Principle 14 – Corporate governance	The supervisor determines that banks and banking groups have robust corporate governance policies and processes covering, for example, strategic direction, group and organizational structure, control environment, responsibilities of the banks’ Boards and senior management, and compensation. These policies and processes are commensurate with the risk profile and systemic importance of the bank.
Principle 15 – Risk management process	The supervisor determines that banks have a comprehensive risk management process (including effective Board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate all material risks on a timely basis and to assess the adequacy of their capital and liquidity in relation to their risk profile and market and macroeconomic conditions. This extends to development and review of contingency arrangements (including robust and credible recovery plans where warranted) that take into account the specific circumstances of the bank. The risk management process is commensurate with the risk profile and systemic importance of the bank.
Principle 16 – Capital adequacy	The supervisor sets prudent and appropriate capital adequacy requirements for banks that reflect the risks undertaken by, and presented by, a bank in the context of the markets and macroeconomic conditions in which it operates. The supervisor defines the components of capital, bearing in mind their ability to absorb losses. At least for internationally active banks, capital requirements are not less than the applicable Basel standards.
Principle 17 – Credit risk	The supervisor determines that banks have an adequate credit risk management process that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk (including counterparty credit risk) on a timely basis. The full credit lifecycle is covered including credit underwriting, credit evaluation, and the ongoing management of the bank’s loan and investment portfolios.
Principle 18 – Problem assets, provisions and reserves	Problem assets, provisions and reserves: The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves.

Principle 19 – Concentration risk and large exposure limits	The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate concentrations of risk on a timely basis. Supervisors set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.
Principle 20 – Transactions with related parties	In order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to enter into any transactions with related parties on an arm's length basis; to monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.
Principle 21 – Country and transfer risks	The supervisor determines that banks have adequate policies and processes to identify, measure, evaluate, monitor, report and control or mitigate country risk and transfer risk in their international lending and investment activities on a timely basis.
Principle 22 – Market risks	The supervisor determines that banks have an adequate market risk management process that takes into account their risk appetite, risk profile, and market and macroeconomic conditions and the risk of a significant deterioration in market liquidity. This includes prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate market risks on a timely basis.
Principle 23 – Interest rate risk in the banking book	The supervisor determines that banks have adequate systems to identify, measure, evaluate, monitor, report and control or mitigate interest rate risk in the banking book on a timely basis. These systems take into account the bank's risk appetite, risk profile and market and macroeconomic conditions.
Principle 24 – Liquidity risk	The supervisor sets prudent and appropriate liquidity requirements (which can include either quantitative or qualitative requirements or both) for banks that reflect the liquidity needs of the bank. The supervisor determines that banks have a strategy that enables prudent management of liquidity risk and compliance with liquidity requirements. The strategy takes into account the bank's risk profile as well as market and macroeconomic conditions and includes prudent policies and processes, consistent with the bank's risk appetite, to identify, measure, evaluate, monitor, report and control or mitigate liquidity risk over an appropriate set of time horizons. At least for internationally active banks, liquidity requirements are not lower than the applicable Basel standards.

Principle 25 – Operational risk	The supervisor determines that banks have an adequate operational risk management framework that takes into account their risk appetite, risk profile and market and macroeconomic conditions. This includes prudent policies and processes to identify, assess, evaluate, monitor, report and control or mitigate operational risk on a timely basis.
Principle 26 – Internal control and audit	The supervisor determines that banks have adequate internal control frameworks to establish and maintain a properly controlled operating environment for the conduct of their business taking into account their risk profile. These include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
Principle 27 – Financial reporting and external audit	The supervisor determines that banks and banking groups maintain adequate and reliable records, prepare financial statements in accordance with accounting policies and practices that are widely accepted internationally and annually publish information that fairly reflects their financial condition and performance and bears an independent external auditor's opinion. The supervisor also determines that banks and parent companies of banking groups have adequate governance and oversight of the external audit function.
Principle 28 – Disclosure and transparency	The supervisor determines that banks and banking groups regularly publish information on a consolidated and, where appropriate, solo basis that is easily accessible and fairly reflects their financial condition, performance, risk exposures, risk management strategies and corporate governance policies and processes.
Principle 29 – Abuse of financial services	The supervisor determines that banks have adequate policies and processes, including strict customer due diligence rules to promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.

Source: Verbatim excerpt from September 2012 Basel Committee on Banking Supervision's *Core Principles for Effective Banking Supervision*, Paragraph 41, pp.10-13, available at <http://www.bis.org/publ/bcbs230.pdf>

9. How Do Asian Jurisdictions' Bank Regulation and Supervision Regimes Compare?

BCP reviews are not audits of regulation and supervisory effectiveness. They are point in time assessments based on discussions with bank supervisory officials and reviews of evidentiary information provided by supervisory authorities in support of their contention that they meet the various BCPs. Even if a bank supervisory authority is in apparent conformity with BCP requirements, the BCP need to be applied in practice to be effective. A supervisory authority's willingness to take timely action cannot be predicted by the FSAP assessors, which is a limiting factor in the FSAP analysis. Nevertheless, the published available BCP assessments provide useful insights into the relative quality of jurisdictions' supervisory regimes. It should be noted that instances of less than full BCP compliance may have been remedied subsequent to the issuance of the assessment.

Jurisdictions are encouraged to conduct BCP self assessments and take action to remedy instances of less than full compliance.

Table 2 presents examples of summary assessments commentary from FSAP reports of two Asian jurisdictions. The assessments used the 2012 version of the BCP, which incorporate lessons learned from the GFC. An index of FSAP Reports from 2001 to the present, including stand-alone BCP assessment reports and BCP assessment in FSAP reports, is available on line at <http://www.imf.org/external/np/fsap/fssa.aspx> with links available to electronic versions of the indexed documents. Four significant Asian jurisdictions will receive an FSAP in 2017 – China, Japan, India, and Indonesia. The 2017 final FSAP reports for these jurisdictions will be available through this link upon completion.

Table 2
Examples of Asian Jurisdictions’ FSAP BCP Assessments

<p>Jurisdiction/ Prudential Regulatory Authority</p>	<p>IMF/World Bank Basel Core Principles (BCP) Assessment Document(s), Date Issued/Name of Document, (Internet address to access referenced country documents valid on 22 May 2017)</p> <p>Assigned Ratings Distribution of the 29 BCP Assessment Areas by Rating Category</p> <p>Relevant Summary Commentary Excerpted from Assessment Documents</p>
<p>Singapore/ Monetary Authority of Singapore</p>	<p>IMF Country Report No. 13/325, November 2013, Financial Stability System Assessment (https://www.imf.org/external/pubs/ft/scr/2013/cr13325.pdf)</p> <p>“The Singapore financial system is highly developed, and well regulated and supervised.” “Singapore’s current regulation and supervision are among the best globally. The Monetary Authority of Singapore (MAS) oversees the entire financial system, and has the analytical and operational capabilities to do so effectively. Singapore is exposed to a broad array of domestic and global risks, especially in light of its interconnectedness with other financial centers. The most pressing vulnerability appears to stem from the rapid growth of credit and real estate prices in recent years, but the financial system is also exposed to possible spillovers from a future tightening of U.S. monetary policy, an economic slowdown in China, or a deterioration of economic conditions in Europe. The team’s stress tests suggest that these risks are manageable. This reflects banks’ large capital and other cushions, and the decisive macroprudential actions taken by MAS to address the threat of a bubble in the housing sector.” “Stress tests suggest that banks are resilient to adverse macroeconomic scenarios.”</p> <p>IMF Country Report No. 13/342, December 2013/Detailed Assessment of Compliance – BCP for Effective Banking Supervision, (https://www.imf.org/en/Publications/CR/Issues/2016/12/31/Singapore-Detailed-Assessment-of-Compliance-on-the-Basel-Core-Principles-for-Effective-41083)</p> <p>Ratings: Compliant: 25, Largely compliant: 4, Materially non-compliant: 0, Non-compliant: 0</p> <p>“The assessment of the Monetary Authority of Singapore (MAS) represents a very high level of compliance with the Basel Core Principles for Effective Banking Supervision and demonstrates a strong commitment by MAS to their implementation.”</p>

<p>China - Hong Kong SAR (HKSAR)/ Hong Kong Monetary Authority (HKMA)</p>	<p>IMF Country Report No. 14/207, July 2014/FSAP-BCP for Effective Banking Supervision, (https://www.imf.org/external/pubs/ft/scr/2014/cr14207.pdf) Ratings: Compliant: 26, Largely compliant: 3, Materially non-compliant: 0, Non-compliant: 0</p> <p>“HKSAR has a very high level of compliance with the Basel Core Principles (BCPs) for Effective Banking Supervision.” “The HKMA is maintaining its commitment to the international regulatory reform agenda and is an early adopter of many standards. Supervisory practices, standards and approaches are well integrated, risk based and of very high quality. A number of the HKMA practices around corporate governance issues, including close and continuing attention to fit and proper standards and to the role played by the Board of an authorized institution...deserve particular commendation.” “Hong Kong banks are well capitalized, profitable and have extremely low levels of nonperforming loans. The banking sector also appears well placed to meet new Basel liquidity standards. Banks’ capital adequacy remains robust at around 16 percent, with banks’ Tier 1 capital ratio at over 13 percent. Solvency stress tests conducted by the HKMA suggest that banks’ capital adequacy is generally resilient to both domestic and external shocks, including sharp increases in interest rates.”</p>
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Another valuable resource in determining jurisdictions’ adoption of standards promulgated by the Basel Committee is a series of very detailed progress reports on adoption of Basel III standards by the 27 Basel Committee member jurisdictions. Asian jurisdictions that are Basel Committee members include: China, Hong Kong SAR, India, Indonesia, Japan, South Korea, and Singapore. The most recent report was issued by the Basel Committee in April 2017, entitled “Twelfth progress report on adoption of the Basel regulatory framework” which is available on-line at www.bis.org/bcbs/publ/d404.htm.

10. Conclusions

Extensive post-GFC regulatory reforms have been promulgated by the Basel Committee, the Financial Stability Board, and various national authorities to enhance the strength and resiliency of individual banks and banking systems, to withstand future periods of adversity and instability. Despite the comprehensive nature of the reforms and preventative measures, they do not eliminate the possibility that destabilizing events can occur. It is prudent for jurisdictions to conduct periodic self-assessments of their bank regulatory and supervisory capabilities against international standards such as the BCP to identify and address any areas needing improvement.

On-going regional financial integration in Asia and attendant cross-border interconnectivity have intensified over the past decade. This has increased the potential for contagion risk, in which problems arising in one jurisdiction can be spread to others through various transmission channels, sometimes quickly. Effective implementation of consolidated supervision, including the legal ability to share confidential supervisory information on a timely basis, is essential to controlling these risks.

The global economy will continue to experience significant structural shifts and volatility that will provide future challenges to financial stability. Strong systems of bank regulation and supervision are necessary to meet those challenges and avoid, dampen or mitigate future periods of financial instability or crisis.

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Endnotes

1. The comments, conclusions and opinions expressed by the author are his own and do not represent the opinions of his current or former employers. Use of the term “country” or “jurisdiction” in this chapter is not intended to make or imply any judgments as to the legal or other status of any territory or area.
2. SMEs and consumers in EMEs who do not have sufficient creditworthiness to obtain loans from banks rely on non-bank lenders for credit, such as finance companies, which may be unregulated or lightly regulated. Banks’ lending activities are usually subject to detailed regulations regarding loan terms and conditions, which seek to reduce the possibility of unfair and deceptive lending practices. Bank credit also typically costs less. Therefore, borrowers attempt to attain a financial standing that allows them to access bank credit.
3. Systemic risk in this context means that the failure of a bank, particularly if it is large or has many interconnections with other banks (such as granting or receiving loans from them), or offers some unique functions for many banks, such as operating a securities market clearing and settlement system, could have negative impacts that jeopardize the stability of those other banks.
4. Michael C. Bonello, Governor of the Central Bank of Malta, 23 May 2011.
5. A bank’s license to do business is, in some jurisdictions, synonymously referred to as its “charter.”
6. Group of Ten (2001), p. 163. This report was prepared by a working party comprised of finance ministry and central bank staff from Australia, Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States, and representatives from the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund and the Organization for Economic Co-operation and Development.
7. OECD (2015), p. 9.
8. Bank examiners are sometimes referred to as “bank supervisors.” Bank supervisors may also refer to: staff supporting bank examiners conducting on-site reviews/ examinations; staff conducting off-site monitoring of banks; or those responsible for overseeing bank supervisory activities.

9. The record of 1966 U.S. Congressional testimony on bank regulatory enforcement powers included a memorandum by then Federal Home Loan Bank Chairman John E. Horne which states that an “unsafe or unsound (banking) practice embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to (a banking) institution, its shareholders, or the agencies administering (deposit) insurance funds.” This definition is frequently cited in judicial and administrative enforcement proceedings involving regulatory supervision of banks. (*Financial Institutions Supervisory and Insurance Act of 1966: Hearings on S. 3158 Before the House Committee on Banking and Currency*, 89th Cong., 2d Sess., 49–50 (1966)).
10. Transaction testing refers to sampling techniques employed by bank examiners in reviewing a bank’s books and records. For example, the focal point of most examinations is a review of loan portfolio quality. Examiners will typically select a sample of loans to review in detail. This review includes analyzing borrowers’ current financial information to assess their ability to repay the loan and an assessment of the protection against loss provided by collateral pledged to secure the loan, such as real estate, in the event the borrower defaults.
11. People’s Republic of China; Taipei, China; Indonesia and South Korea.
12. Thirteen of the 147 identified systemic banking crises were characterized as “borderline” events, meaning that while they met the crisis definition, they were less severe events.
13. Moral hazard occurs when a party to a transaction takes excessive risk, knowing that the impact of an adverse outcome will not be borne by them.
14. Contagion risk in this context is the risk that financial weaknesses or problems in one affiliate can be transmitted to affiliated organizations through various mechanisms, such as interbank loans, or the sale of poor quality assets.
15. BCBS/Joint Forum (2012), p. 3.
16. Prompt corrective action, also known as PCA, refers to banking laws that mandate increasingly stringent operating restrictions on undercapitalized banks, up to and including license revocation. The general objective of PCA is to close nonviable institutions or transfer their operations to new ownership well before book capital is zero or negative, to minimize losses. PCA frameworks usually mandate that regulators impose more stringent restrictions as capital levels decline. Restrictions can include dividend prohibitions, curtailment of non-deposit borrowings, asset growth, executive compensation limitations, and removal/replacement of senior executives.

17. Sixty central banks are listed as having rights of voting and representation per “The BIS in profile,” (Basel: BIS), updated 27 June 2016, available on-line at <http://www.bis.org/about/profile.htm>.
18. The Basel Committee on Banking Supervision (“BCBS”) consists of senior representatives of bank supervisory authorities and central banks. Member jurisdictions are: Argentina; Australia; Belgium; Brazil; Canada; China; the European Union; France; Germany; Hong Kong, China; India; Indonesia; Italy; Japan; Korea; Luxembourg; Mexico; the Netherlands; Russia; Saudi Arabia; Singapore; South Africa; Spain; Sweden; Switzerland; Turkey; the United Kingdom and the United States. Source: BCBS website September 2016: www.bis.org/bcbs/membership.htm.
19. BCBS (2012), p. 3.