Annex I

Core Principles for Effective Banking Supervision[1] (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[2] 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—Principle 22, and
Cross-border banking—Principles 23 to 25.

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

5. National agencies should apply the Principles in the supervision of all banking organisations within their jurisdictions.[3] The Principles are **minimum requirements** and in many cases may need to be supplemented by other measures designed to address particular conditions and risks in the financial systems of individual countries.

6. The Basle Core Principles are intended to serve as a basic reference for **supervisory and other public**

[1]Basle Committee on Banking Supervision, Basle, September 1997.

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

[3]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.

authorities in all countries and internationally. It will be for national supervisory authorities, many of which are actively seeking to strengthen their current supervisory regime, to use the attached document to review their existing supervisory arrangements and to initiate a programme designed to address any deficiencies as quickly as is practical within their legal authority. The Principles have been designed to be verifiable by supervisors, regional supervisory groups, and the market at large. The Basle Committee will play a role, together with other interested organisations, in monitoring the progress made by individual countries in implementing the Principles. It is suggested that the IMF, the World Bank and other interested organisations use the Principles in assisting individual countries to strengthen their supervisory arrangements in connection with work aimed at promoting overall macroeconomic and financial stability. Implementation of the Principles will be reviewed at the International Conference of Banking Supervisors in October 1998 and biennially thereafter.

7. Supervisory authorities throughout the world are encouraged to **endorse** the Basle Core Principles. The members of the Basle Committee and the sixteen other supervisory agencies that have participated in their drafting all agree with the content of the document.

8. The chairpersons of the **regional supervisory groups**[4] are supportive of the Basle Committee's efforts and are ready to promote the endorsement of the Core Principles among their membership. Discussions are in progress to define the role the regional groups can play in securing the endorsement of the Principles and in monitoring implementation by their members.

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

[4]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.

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

List of Core Principles for Effective Banking Supervision

Preconditions for Effective Banking Supervision

1. An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of 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.

Section 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)[5] 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.

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

In some countries responsibility for licensing banks is separate from the process of ongoing supervision. It is clearly essential that, wherever the responsibility

[5]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.

lies, the licensing process establishes the same high standards as the process of ongoing supervision which is the main focus of this paper. Section III therefore discusses some principles and issues that should be addressed in the licensing process.

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

Section II: Preconditions for Effective Banking Supervision

Banking supervision is only part of wider arrangements that are needed to promote 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* is 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. Forbearance, 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)[6] and ahead of shareholders, subordinated debt holders and other connected parties.

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

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.

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.

Section III: Licensing Process and Approval for Changes in Structure

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

Principle 3. The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the 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"[7] in names should be controlled to the extent possible in those circumstances where the general public might be misled by unli-

[7]This includes any derivations of the word "bank," including "banking."

censed, 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 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.

A. Ownership Structure

Supervisors must be able to assess the ownership structure of banking organisations. This assessment should include the bank's direct and indirect controlling and major[8] 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.

B. Operating Plan, Systems of Control and Internal Organisation

Another element to review during the licensing process is the operations and strategies proposed for the bank. The operating plan should describe and analyse the market area from which the bank expects to draw the majority of its business and establish a strategy for the bank's ongoing operations. The application should also describe how the bank will be organised and controlled internally. The licensing agency should determine if these arrangements are consistent with the proposed strategy and 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 and compliance functions) and that the "four eyes" principle

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

(segregation of various functions, cross-checking, dual control of assets, double signatures, etc.) will be followed. It is essential to determine that the legal and operational structures will not inhibit supervision on either a solo or consolidated basis and that the supervisor will have adequate access to management and information. For this reason, supervisors should not grant a licence to a bank when the head office will be located outside its jurisdiction unless the supervisor is assured that it will have adequate access to management and information. (See Section E below for licensing of banks incorporated abroad.)

C. Fit and Proper Test for Directors and Senior Managers

A key aspect of the licensing process is an evaluation of the competence, integrity and qualifications of proposed management, including the board of directors.[9] The licensing agency should obtain the necessary information about the proposed directors and senior managers to consider individually and collectively their banking experience, other business experience, personal integrity and relevant skill. This evaluation of management should involve background checks on whether previous activities, including regulatory or judicial judgements, raise doubts concerning their competence, sound judgement, or honesty. It is critical that the bank's proposed management team includes a substantial number of individuals with a proven track record in banking. Supervisors should have the authority to require notification of subsequent changes in directors and senior management and to prevent such appointments if they are deemed to be detrimental to the interests of depositors.

D. Financial Projections Including Capital

The licensing agency should review pro forma financial statements and projections for the proposed bank. The review should determine whether the 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.

E. Prior Approval from the Home Country Supervisor When the Proposed Owner Is a Foreign Bank (see also Section VI.B.)

When a foreign bank, subsidiary of a foreign banking group, or a foreign non-banking financial institution (subject to a supervisory authority) proposes to establish a local bank or branch office, the licensing authority should consider whether the Basle Minimum Standards[10] 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.[11] In assessing whether capable consolidated supervision is provided, the host licensing authority should consider not only the nature and scope of the home country supervisory regime but also whether the structure of the applicant or its group is such as to not inhibit effective supervision by the home and host country supervisory authorities.

F. Transfer of a Bank's Shares

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

In addition to licensing new banks, banking supervisors should be notified of any future significant direct or indirect investment in the bank or any increases or other changes in ownership over a particular threshold and should have the power to block such investments or prevent the exercise of voting rights in respect of such investments if they do not meet criteria comparable to those used for approving new banks. Notifications are often required for ownership or voting control involving established percentages of a bank's outstanding shares.[12] The threshold for approval of significant ownership changes may be higher than that for notification.

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[9] With regard to the "fit and proper" evaluation, where appropriate, differentiation can be made between the supervisory board and the executive board.

[10] See "*Minimum standards for the supervision of international banking groups and their cross-border establishments*"—Volume III of the Compendium.

[11] 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.

[12] These established percentages typically range between 5 and 10%.

G. Major Acquisitions or Investments by a Bank

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

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

In certain circumstances, supervisors require banks to provide notice or obtain explicit permission before making certain acquisitions or investments. In these instances, supervisors need to determine if the 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.

Section IV: Arrangements for Ongoing Banking Supervision

A. Risks in Banking

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

Credit Risk

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

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

Connected lending—the extension of credit to individuals or firms connected to the bank through ownership or through the ability to exert direct or indirect control—if not properly controlled, can lead to significant problems because determinations regarding the creditworthiness of the borrower are not always made objectively. Connected parties include a bank's parent organisation, major shareholders, subsidiaries, affiliated 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 marketplace.

B. Development and Implementation of Prudential Regulations and Requirements

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

1. Capital Adequacy

Principle 6. Banking supervisors must set 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.[13] Many other countries have adopted the Capital Accord or something very close to it. The Accord addresses two important elements of a bank's activities: (1) different levels of credit risk inherent in its balance sheet and (2) off-balance sheet activities, which can represent a significant risk exposure.

The Accord defines what types of capital are acceptable for supervisory purposes and stresses the need for adequate levels of "core capital" (in the accord this capital is referred to as tier one capital) consisting of permanent shareholders' equity and disclosed reserves that are created or maintained by appropriations of retained earnings or other surplus (e.g., share premiums, retained profit, general reserves and reserves required by law). Disclosed reserves also include general funds that meet the following criteria: (1) allocations to the funds must be made out of post-tax retained earnings or out of pre-tax earnings adjusted for all potential tax liabilities; (2) the funds and movements into or out of them must be disclosed separately in the bank's published accounts; (3) the funds must be available to a bank to meet losses; and (4) losses cannot be charged directly to the funds but must be taken through the profit and loss account. The Accord also acknowledges other forms of supplementary capital (referred to as tier two capital), such as other forms of reserves and hybrid capital instruments that should be included within a system of capital measurement.

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

The Accord sets minimum capital ratio requirements for internationally active banks of 4% tier one capital and 8% total (tier one plus tier two) capital in relation to risk-weighted assets.[14] These requirements are applied to banks on a consolidated basis.[15] 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.

[13]See "*International convergence of capital measurement and capital standards*"—Volume I of the Compendium.

[14]Although the Accord applies to internationally active banks, many countries also apply the Accord to their domestic banks.

[15]Supervisors should, of course, also give consideration to monitoring the capital adequacy of banks on a non-consolidated basis.

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.

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.[16] 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 nonbank 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 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.[17]

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.

[16] 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.

[17] These issues were addressed in a 1982 Basle Committee paper "*Management of banks' international lending*"—Volume I of the Compendium.

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.[18] Banking supervisors should also ensure that bank management has set appropriate limits and implemented adequate internal controls for their foreign exchange business.[19]

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[20] 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.[21] In addition, supervisors should receive sufficient and timely information from banks in order to evaluate the level of interest rate risk. This information should take appropriate account of the range of maturities and currencies in each bank's portfolio, as well as other relevant factors such as the distinction between trading and non-trading activities.

(ii) Liquidity management

The purpose of liquidity management is to ensure that the bank is able to meet fully its contractual commitments. Crucial elements of strong liquidity management include good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, and contingency planning.[22] 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.

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[18]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.

[19]See "*Supervision of banks' foreign exchange positions*"—Volume I of the Compendium.

[20]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.

[21] 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.

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

5. Internal Controls

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

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

The purpose of internal controls is to ensure that the business of a bank is conducted in a prudent manner in accordance with policies and strategies established by the bank's board of directors; that transactions are only entered into with appropriate authority; that assets are safeguarded and liabilities controlled; that accounting and other records provide complete, accurate and timely information; and that management is able to identify, 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.[23] 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.

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.[24] 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

[23] 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.

[24] See "*Prevention of criminal use of the banking system for the purpose of money-laundering*"—Volume I of the Compendium.

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.

C. Methods of Ongoing Banking Supervision

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

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

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

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

Principle 20. An essential element of banking supervision is the ability of the supervisors to supervise the banking 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 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 ongoing 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[25]

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;

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

- 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.

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.[26] In many instances, these discussions should also include the bank.

[26] 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.

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.[27] Banking supervisors should also have the ability to coordinate with other authorities responsible for supervising specific entities within the organisation's structure.

D. 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. 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

[27] The Basle Committee recommended supervision on a consolidated basis in its paper "*Consolidated supervision of banks' international activities*"—Volume I of the Compendium.

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, non-performing 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[28] 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 com-

[28]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.

prehensive and not misleading. This information should be timely and sufficient for market participants to assess the risk inherent in any individual banking organisation.[29]

Section V: 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.

A. Corrective Measures

Despite the efforts of supervisors, situations can occur where banks fail to meet supervisory requirements or where their solvency comes into question. In order to protect depositors and creditors, and prevent more widespread contagion of such problems, supervisors must be able to conduct appropriate intervention. Banking supervisors must have at their disposal adequate supervisory measures to bring about 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.

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

B. Liquidation Procedures

In the most extreme cases, and despite ongoing attempts by the supervisors to ensure that a problem situation is resolved, a banking 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.

Section VI: Cross-Border Banking

The Principles set out in this section are consistent with the so-called Basle Concordat and its successors.[30] 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 cross-border 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.

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

[30] 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.

A. 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 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 cannot be developed to give sufficient comfort, bearing in mind the risks involved, then the home supervisor may have no option but to request the closure of the relevant overseas establishment.

B. Obligations of Host Country Supervisors

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

Foreign banks often provide depth and increase competition 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.

APPENDIX I

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.[31] 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 government-owned 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.

[31]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.

APPENDIX II

Deposit Protection

Despite the efforts of supervisors, bank failures can occur. At such times, the possible loss of all or part of their funds increases the risk that depositors will lose confidence in other banks. Consequently, many countries have established deposit insurance plans to protect small depositors. These plans are normally organised by the government or central bank, or by the relevant bankers' association 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 pursues high-risk strategies, thus weakening an important check on imprudent management. Government officials and supervisors need to recognise this effect of a safety net and take steps to prevent excessive risk-taking by banks. One method of limiting risk-taking is to utilise a deposit insurance system consisting of "co-insurance." Under such a system, the deposit insurance covers a percentage (e.g., 90%) of individual deposits and/or provides cover only up to a certain absolute amount so that depositors still have some funds at risk. Other methods include charging risk-based premiums or withholding deposit insurance from large, institutional depositors.

The actual form of such a programme should be tailored to the circumstances in, as well as historical and cultural features of, each country.[32]

[32]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*"—Volume III of the Compendium.

Annex II

IOSCO Principles and Recommendations for the Regulation and Supervision of Securities Markets

I. IOSCO: Structure and Objectives

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

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

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

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

II. The Work of IOSCO: Consensus and Cooperation

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

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

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

III. Working to Meet the Needs of Emerging Securities Markets

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

Prepared for the G-10 Working Group on Financial Stability in Emerging Market Economies, Montreal, April 7, 1997.

bership structure, and the participation of both emerging and developed economies in all of IOSCO's work.

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

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

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

The Technical Committee and the EMC have adopted parallel working group structures. The EMC Working Groups pursue their mandates in two parallel directions: (1) issues of specific interest to EMC members; and (2) issues being examined by the parallel Technical Committee Working Group. The Technical Committee and the EMC have also agreed to exchange observers on Working Groups in order to enhance practical cooperation. The EMC Working Group chairmen therefore receive and provide input from and to the Technical Committee Working Groups. This high degree of coordination and cooperation between the two Committees enables the EMC to better focus its resources on some of the practical difficulties specifically encountered by its members.

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

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

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

IV. Working Groups and Coordination of Regulatory Initiatives

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

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

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

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

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

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

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

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

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

E. Working Group No. 5 on Investment Management:

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

V. Substantially All of IOSCO's Work Program and Regulatory Initiatives Are Intended to Foster Sound Regulatory Principles in Emerging and Developed Markets

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

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

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

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

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

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

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

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

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

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

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

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

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

- the **publication of a list of information items that should be available to market participants** as to market default procedures regarding futures and options trading;
- a **recommendation on Communications upon Implementation of Default Procedures**;
- **recommendations for Best Practices on the Treatment of Positions, Funds and Assets in the Event of the Default of a Member Firm**. These recommendations are designed to permit prompt isolation of problems in order to minimize systemic risk.

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

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

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

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

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

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

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

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

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

Additional IOSCO measures to improve disclosure standards include:

- development of **international standards for non-financial statements disclosures** for use by foreign issuers in cross-border offerings and listings;
- publication in 1994 of **recommendations for minimum disclosure standards for public securities offerings** and a *Model Prospectus for Emerging Markets;* and
- publication in 1996 of **guidelines for the reporting of material events by issuers of publicly traded securities in emerging markets** (*Reporting of Material Events*).

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

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

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

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

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

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

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

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

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

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

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

- the world-wide growth of the OTC derivatives business led to the adoption by IOSCO in March 1996 of a **recommendation on the *Recognition of Bilateral Netting Agreements in the Calculation of Capital Requirements for Securities Firms***. This recommendation takes note of the increasing importance of the OTC derivatives business as a proportion of the overall business of securities firms, and encourages the use of legally enforceable bilateral netting agreements by authorized securities firms;
- the growth in derivatives trading activity in the securities sector has prompted firms to develop methods to analyse, control and report their trading risk in a consistent and reliable way. Firms have increasingly been turning to more sophisticated quantitative based risk management methodologies using modern option and portfolio theory. This trend has led to the development of value at risk modelling techniques. The IOSCO Technical Committee is currently considering the appropriateness of the use of value at risk models by securities regulators for capital adequacy purposes and continues to cooperate with the Basle Committee on model testing and analysis. The basis for this consideration is the July 1995 report on the *Implications for Securities Regulators of the Increased Use of Value-at-Risk Models by Securities Firms*. This Report recognises the role played by value at risk models in improving internal controls and risk-based capital standards for securities firms. The Report explains how the value at risk models are constructed, points out the role that models should play as part of a firm's risk management procedures, and considers the implications for securities regulators of recognising the output of value at risk models for the purpose of calculating capital requirements for market risk.

IOSCO recognizes that supervisors should continuously improve their understanding of how exchange-traded and OTC derivatives affect the overall risk profile and profitability of market intermediaries. IOSCO and the Basle Committee have set out **guidelines for the types of information that regulators and supervisors should obtain from banks and securities firms in order to form a judgement as to the risks associated with proprietary and client-based derivative trading activities** (*Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms* (May 1995)).

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

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

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

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

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

G. Establishing Standards of Regulation for Collective Investment Schemes

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

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

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

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

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

VI. Conclusion

The dramatic increase in securities transactions and the increasingly globalized marketplace has set new challenges for securities regulators world-wide. The members of IOSCO recognize that market integrity, investor protection and financial stability can only be achieved through a high level of cooperation and communication. IOSCO provides the forum for that cooperation and communication, allowing members to share their expertise, make concrete their commitment to the goals of market integrity and investor protection, provide practical assistance to other members, and supply critical leverage to regulators seeking to influence domestic legislation and regulation. IOSCO's commitment to these goals, accompanied by its global reach, participation by members at the highest level, and consensus-building have enabled IOSCO to make important contributions to the development of sound securities regulatory principles in both emerging and developed markets.

APPENDIX

Activities of the EMC Working Groups

EMC activities, particularly those of its Working Groups, have strengthened the cooperation between its members and have contributed to the development of an integrated approach for the development of standards for improving the transparency of emerging securities and futures markets.

A. Working Group No. 1: Disclosure and Accounting

In coordination with the Working Group No. 1 of the Technical Committee, the Working Group is addressing the development of standards to facilitate multi-jurisdictional securities offerings, which take into account the market experiences and particularities of EMC members. It is also working towards developing a set of recommendations of Interim Reporting in relation to "*Presentation of Financial Statements*". In its last meeting, the EMC approved the report entitled "*Reporting Material Events*".

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

This Working Group has a specific mandate to develop a legal and regulatory framework for cash and derivative markets in emerging jurisdictions.

A Report entitled "*The Legal and Regulatory Framework for Exchange Traded Derivatives*" was made public at IOSCO's most recent Annual Conference and serves as a very useful reference document for jurisdictions considering the development of derivatives markets. The report encompasses the following issues and regulatory objectives:

- Market Integrity and Efficiency: Product Design, Order Execution; Surveillance and Operational Capacity;

- Financial Safety and Integrity: Capital Standards; Clearing Facility; Margins; Protection of Customers Funds; Default, Insolvency of Bankruptcy Provisions, Market Disruptions;
- Customer Protection and Fairness: Automation/Registration/Licensing; Order Execution; Record Keeping; Sales Representation and Disclosure; Product Design; Dispute Resolution Programs;
- Compliance and Enforcement.

The EMC has also authorized the Working Group to develop a legal framework to support the operations of central securities depositories and to offer a greater degree of legal certainty to participants. Two other mandates relate to financial risk management in emerging derivatives markets and transparency relating to block trading.

C. Working Group No. 3: Regulation of Market Intermediaries

This Working Group has a specific mandate to identify the objectives and criteria of capital adequacy standards enforced in the jurisdictions of EMC members along with the type of risks involved. It is also developing a comparative analysis of the regulatory approaches used by EMC members, including a description of regulatory issues in the area of the regulation of market intermediaries. The Working Group is planning to design a capital adequacy regime for jurisdictions represented within the EMC, which would use a variable approach depending on the level of development of capital markets and, in particular, the degree of sophistication of the financial instruments used.

The EMC gave the Working Group a new mandate pertaining to short selling and securities lending by market intermediaries and has also asked the Working Group to assist its Technical Committee Working Party counterpart in the preparation of a self-evaluation questionnaire to determine the level of implementation by IOSCO members of the recommendations contained in the Technical Committee report on *Client Asset Protection.*

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

Working Group No. 4 has a specific mandate to create conditions for improving and sharing enforcement expertise among EMC members. It is encouraging the efforts of EMC members to combat international securities fraud, and at the same time is working on the identification of principles of securities regulation in areas such as the organization of regulatory and supervisory systems, and the investigation and enforcement powers of supervisory authorities. The Working Group drafted the two Resolutions adopted by the EMC in September 1996, namely "*Proposal of Recommendation on Standard Catalogue of Illicit Activities to be Recognized and Penalized on the Securities Markets*" and "*Proposal of Recommendation on the Enforcement Powers of a Securities and Futures Markets Supervisory Agency.*"

It has also started work on its mandate relating to the development of guidelines for surveillance techniques and practices for detecting and prosecuting, for law enforcement purposes, price manipulation on the securities markets.

At its most recent meeting, the EMC approved a report entitled "*Discussion Paper on Class Action or Other Provisions Designed to Protect the Interest of Defrauded Investors in Civil Proceedings.*"

E. Working Group No. 5: Investment Management

EMC Working Group No. 5 has a specific mandate to determine regulatory objectives for the promotion and supervision of investment management services and to structure an appropriate regulatory framework for EMC members that would take into consideration high, medium or low intensity regulation.

The Working Group also has to evaluate the role of the regulatory authorities and to prepare a comparative analysis of the different systems used for the promotion or development of investment management services in developed as well as emerging markets.

The EMC recently approved a Report entitled "*Collective Investment Schemes*" which concentrates on the needs of emerging markets regulators pertaining to the regulations of CIS. The Report also embodies basic principles for the development and supervision of CIS and also includes a comparative analysis of the CIS regulatory regimes in 4 EMC countries.

The Working Group plans also to address issues relating to cross-border marketing of CIS.

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