

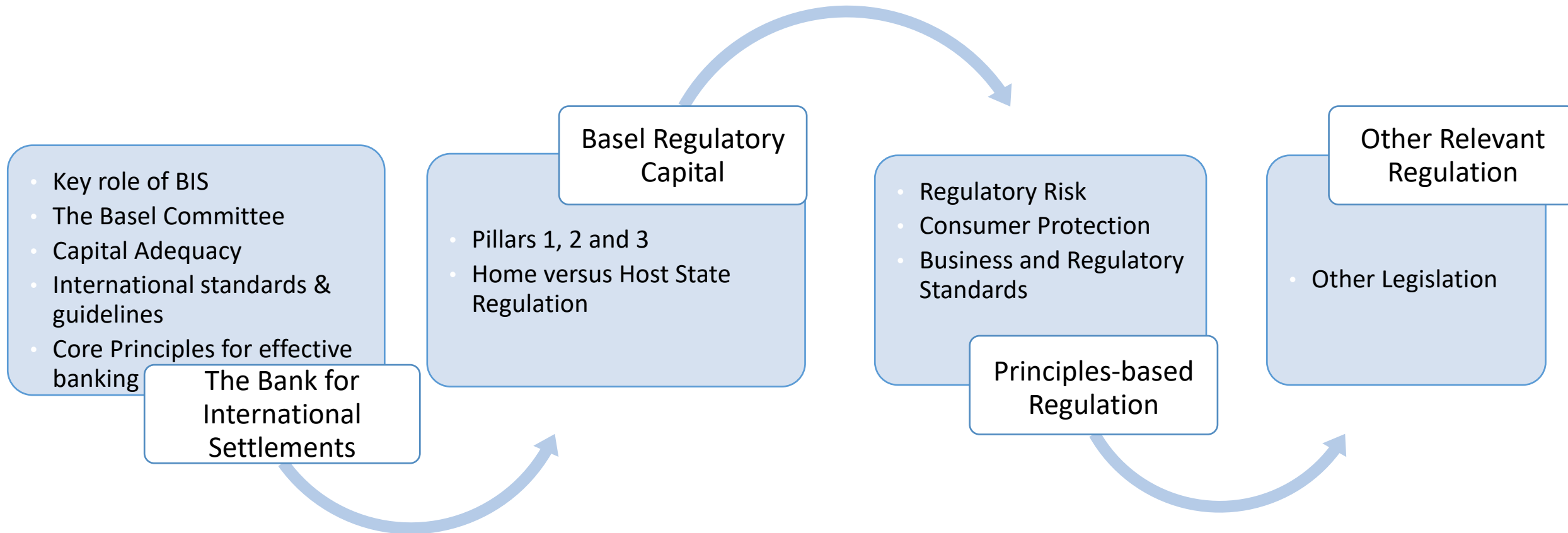
## Chapter 2

# International Risk Regulation

Questions - 7



# Chapter Summary



# The Bank for International Settlements (BIS)

## Key Role of the Bank for International Settlementment

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The BIS is an organization which serves as a bank for **central banks** and **fosters international monetary and financial cooperation**.

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It is the world's oldest international financial organisation and provides a focal point for **research** and **cooperation** in international banking regulation – the 'regulators' regulator'.

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The regulatory guidelines produced by the BIS do not have any force in **national** or **international law**, and countries around the world that choose to implement them do so by making changes to their own legal and regulatory processes



BANK FOR  
INTERNATIONAL  
SETTLEMENTS



# Basel Committee on Banking Supervision

The fundamental business of banking is to provide a safe means of storage for **depositor funds**, and to provide loans to businesses and individuals.

The main risk for a bank was credit risk, through holding illiquid portfolios of loans supported by **shorter-term deposits**

**Lender-of-last-resort** provisions were introduced, to reduce the risk of future bank runs.

One solution was to require banks to hold a **minimum level of capital**.



# International Standards on Capital Adequacy

The Basel Committee on Banking Supervision (BCBS) is the primary global standard-setter for the **prudential regulation** of banks and provides a forum for cooperation on banking supervisory matters.

Enhancements to the Accord (now known **as Basel III**) have introduced several concepts beyond capital ratios, including:

- A **countercyclical capital buffer**, which places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts
- A leverage ratio – a minimum amount of **loss absorbing capital** relative to all of a bank's assets and off-balance sheet exposures regardless of risk weighting.
- A set of liquidity requirements/ratios



# International Standards and Guidelines

The Committee seeks to achieve its aims by setting minimum standards for the **regulation** and **supervision** of banks.

Approaches and techniques to promote common understanding and to improve **cross-border cooperation**

Exchanging information on developments in the banking sector and **financial markets** to help identify current or emerging risks for the global financial system



# Core Principles for Effective Banking Supervision

A series of national preconditions are also defined which provide a framework within which effective banking supervision can take place.

The preconditions are:

1. Sound and sustainable **macroeconomic policies**.
2. A well-established framework for **financial stability policy** formulation.
3. A well-developed **public infrastructure**, including -
  - well-established **private property laws and business laws**
  - **rules governing** financial markets
  - **well-regulated** accounting, auditing and legal professions
  - **efficient payment systems** for the settlement of financial transactions to control counterparty risk
  - an efficient and **independent judiciary**



# Core Principles for Effective Banking Supervision

The preconditions continued -

4. A clear framework for **financial crisis management**, recovery and resolution.
5. Mechanisms for providing an appropriate level of **systemic protection** or public safety net.
6. Effective market discipline





# Core Principles for Effective Banking Supervision

The **29 Core Principles** for Effective Banking Supervision are categorised into **seven groups**, and have become the de facto global standard for sound regulation and supervision of banks:

- **Principles 1–13** address **supervisory powers, responsibilities and functions**
- **Principles 14–29** cover **supervisory expectations of banks**, emphasising the importance of good corporate governance and risk management & compliance with supervisory standards.



# The 29 Core Principles

## Supervisory powers, responsibilities and function

### Principle 1 - Responsibilities, objectives and powers

A suitable legal framework for banking supervision provides each **responsible authority** with the legal powers to **authorize banks, conduct ongoing supervision, address compliance** with laws and undertake corrective actions to address safety and soundness concerns.

### Principle 2 – Independence, accountability, resourcing and legal protection for supervisors

The supervisor possesses **operational independence, transparent processes, sound governance**, budgetary processes that do not undermine autonomy and adequate resources and is accountable for the discharge of its duties and use of its resources.

### Principle 3 – Cooperation and collaboration

Laws, regulations or other arrangements provide a **framework for cooperation and collaboration** with relevant domestic authorities and foreign supervisors



# The 29 Core Principles

## Principle 4 – Permissible activities

The permissible activities of institutions that are **licensed** and subject to **supervision** as banks are defined and the use of the word 'bank' in names is controlled.

## Principle 5 – Licensing criteria

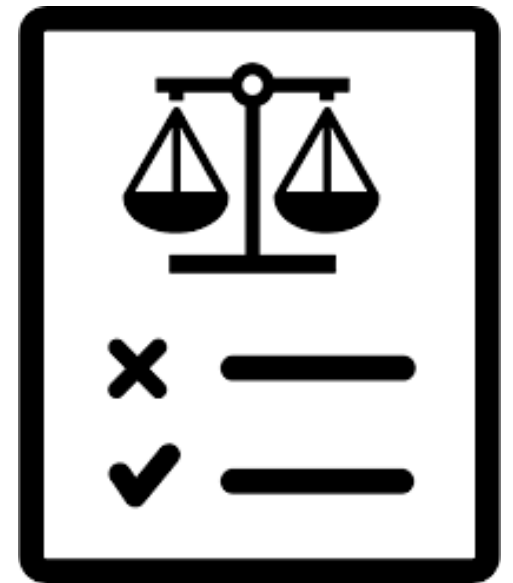
The licensing authority has the power to set **criteria and reject applications** for establishments that do not meet the criteria

## Principle 6 – Transfer of significant ownership

The supervisor has the power to **review, reject and impose prudential conditions** on any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties

## Principle 7 – Major acquisitions

The supervisor has the power to **approve or reject and impose prudential conditions** on, major acquisitions or investments by a bank



## What is Leverage Ratio?

- A. A minimum amount of loss absorbing capital relative to all of the bank's assets .
- B. A ratio that determines that bank has adequate assets.
- C. A ratio of the cooperation to the collaboration.
- D. The amount of the permissible activities in a bank.

**EXAM** FOCUS



# The 29 Core Principles

## Principle 8 – Supervisory approach

An effective system of banking supervision requires the supervisor to:

- Develop and maintain a forward-looking assessment of **the risk profile of individual banks**
- **Identify, assess and address** risks emanating from banks
- Have a **framework in place** for early intervention,
- Take action to **resolve banks** in an orderly manner if they become non-viable.

## Principle 9 – Supervisory techniques and tools

The supervisor uses an appropriate **range of techniques to implement** the supervisory approach and deploys **supervisory resources** on a proportionate basis



# The 29 Core Principles

## Principle 10 – Supervisory reporting

The supervisor collects and reviews **prudential reports** and **statistical returns** from banks.

## Principle 11 – Corrective and sanctioning powers of supervisors

The supervisor acts at an early stage to address **unsafe** and **unsound practices** that could pose risks to banks.

## Principle 12 – Consolidated supervision

An **essential element of banking supervision** is that the supervisor supervises the banking group on a consolidated basis.

## Principle 13 – Home-host relationships

Home and host supervisors of **cross-border banking groups** share information and cooperate for effective supervision of the group



# The 29 Core Principles

## Prudential regulations and requirements

**Principle 14 – Corporate governance** - The supervisor determines there are processes covering:

- **strategic direction, group and organisational structure**
- **control environment**
- **responsibilities of the banks' Boards and senior management, and compensation.**

These policies and processes are commensurate with the risk profile and systemic importance of the bank.

## Principle 15 – Risk Management Process

Banks should have a comprehensive process including **effective board & senior management oversight** to identify, evaluate & report all risks.



# The 29 Core Principles

**Principle 16 – Capital Adequacy** - requirements for banks that:

- reflect the **risks undertaken by, and presented by**, a bank in the context of the **markets and macroeconomic conditions**
- defines the components of capital, bearing in mind their **ability to absorb losses**
- for **internationally active banks**, capital requirements are not less than the applicable Basel standards.

**Principle 17 – Credit Risk** - The supervisor determines that banks:

- Process that considers their **risk appetite, risk profile** and **market & macroeconomic conditions**.
- Policies and processes to **identify, measure, evaluate, monitor, report and control or mitigate** credit risk on a timely basis
- **Credit lifecycle** is covered including credit underwriting, credit evaluation, and the ongoing management of the bank's loan and investment portfolios.





# The 29 Core Principles

**Principle 18 – Problem assets, provisions and reserves** – Supervisor determines Policies and processes for the **early identification** of problem assets, and maintenance provisions and reserves.

**Principle 19 – Concentration risk and large exposure limits** – Supervisor determines Policies and processes to **identify, control or mitigate** concentrations of **risk on a timely basis**

**Principle 20 – Transactions with related parties** - the supervisor requires banks:

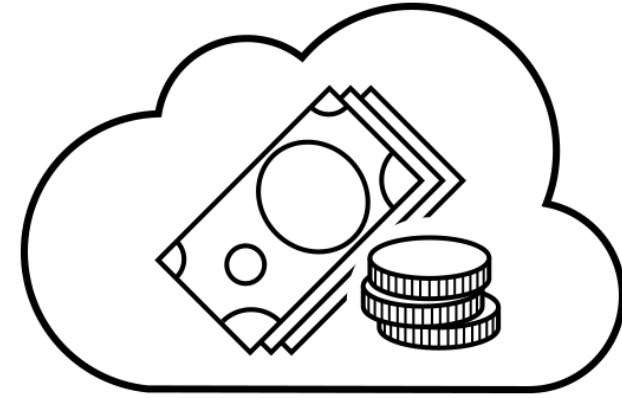
- To enter into any transactions with **related parties** on an arm's length basis
- To **monitor** these transactions
- To take **appropriate steps** to **control or mitigate the risks**
- To **write off exposures** to related parties in accordance with standard policies and processes



# The 29 Core Principles

## Principle 21 – Country and transfer risks

Adequate policies and processes to identify, control or mitigate **country risk**.



## Principle 22 – Market risks

Takes into account the **risk appetite, risk profile, and market** and macroeconomic conditions and the **risk of deterioration in market liquidity**

## Principle 23 – Interest rate risk in the banking book

Systems to identify, control or mitigate interest rate risk in the banking book on a timely basis.



## Principle 24 – Liquidity risk

The supervisor sets **prudent** and appropriate **liquidity requirements** for banks that reflect the liquidity needs of the bank.



## What do country and transfer risks determine?

- A. Banks have adequate policies and processes to identify, control or mitigate country risk.
- B. Banks have power to set criteria and reject applications for establishments that do not meet the criteria
- C. The supervisor collects and reviews prudential reports and statistical returns from banks.
- D. Banks have adequate policies and processes for the early identification of problem assets

**EXAM** FOCUS



# The 29 Core Principles

**Principle 25 – Operational risk** - The supervisor determines that banks have an adequate **operational risk** management framework.



**Principle 26 – Internal control and audit** - determines that banks have adequate **internal control frameworks**

These include:

- clear arrangements for **delegating authority and responsibility**
- **separation of the functions** that involve committing the bank, paying away its funds, and accounting for its assets and liabilities
- **reconciliation of these processes**
- **safeguarding the bank's assets**
- independent internal audit and compliance functions to test **adherence to these controls** as well as applicable laws and regulations



# The 29 Core Principles

**Principle 27: Financial reporting and external audit** - supervisor determines Adequate and **reliable records** in accordance with accounting policies.

**Principle 28 – Disclosure and transparency** – supervisor determines Banks **regularly publish information** on their financial condition, performance, risk exposures, corporate governance policies and processes

**Principle 29 – Abuse of financial services – Supervisor determines** **Strict customer due diligence rules** to promote **high ethical** and **professional standards** in the financial sector and prevent the bank from being used for criminal activities



# Basel Regulatory Capital – The Basel Accord



## PILLAR 1

### Minimum regulatory capital requirements

This involves applying 'formulaic' methods for Calculation.

The formula

$$\frac{\text{capital}}{\text{credit risk} + \text{market risk} + \text{operational risk}} > 8\%$$



## PILLAR 2

### Supervisory review process

- This involves **firms submitting information**
- Enable the regulator to assess the amount of **capital that should be held**
- Risk not covered in Pillar 1
- How risks are managed
- Quality of control's infrastructure
- Calculated Risk Profile & relation to strategic & financial plans



## PILLAR 3

### Market discipline

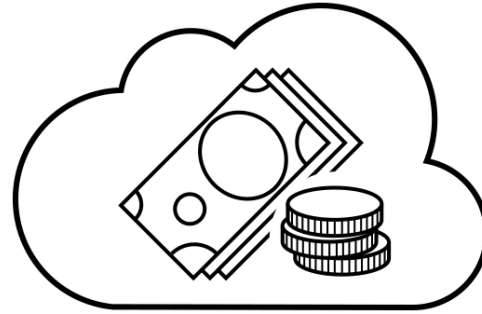
- Firms are required to publish information about the way they **manage the risks** they face.



# Sound Practice Principles



Operational risk



Liquidity risk



CREDIT RISK



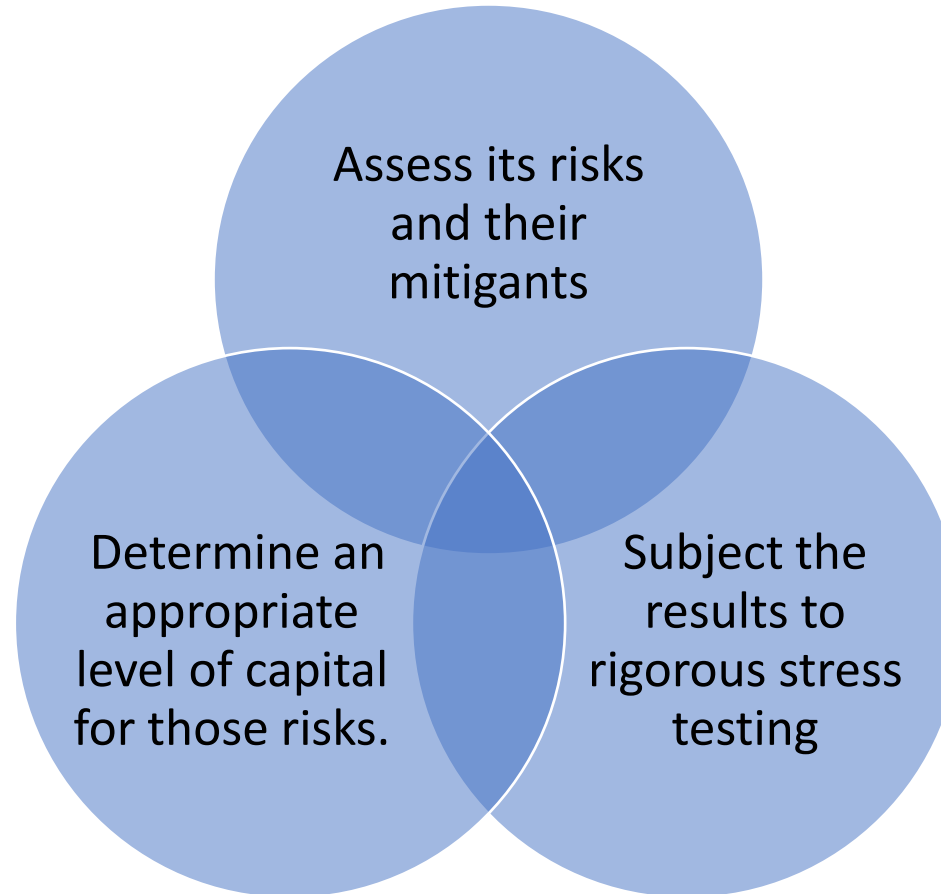
Interest rate risk



# The Internal Capital Adequacy Assessment Process (ICAAP)

It requires firms to submit **risk** and **capital information** to enable the regulator to assess the amount of capital that should be held.

Establish an ICAAP to meet The Basel Pillar 2 requirements and requires a firm to:





# The Key Elements of the ICAAP Framework

## The Firm's Risk Exposure

This provides a clear articulation of the firm's **risk appetite** by risk category.

## The Firm's View on the Adequacy of its Risk Management Processes

This enables the firm to justify holding less capital than the **gross risks** to which it is exposed.

## The Firm's Financial and Capital Plan

This would include a summary of the current and **projected financial** and **capital positions**.

## Stress and Scenario Tests Applied by the Firm to its Risks and Financial Plan

**Stress testing** – varying **one input factor at a time**

**Scenario analysis** – constructing **realistic scenarios**



# The Key Elements of the ICAAP Framework

## The Firm's Capital Adequacy

The **capital** and **dividend** plan needs to be compared to the aggregated results of the various separate risk assessments.

## The Use Test – the Extent to Which the ICAAP is Embedded within the Firm

Senior management or board challenge, **review** and **sign-off procedures**.

## Setting the Regulatory Capital Level

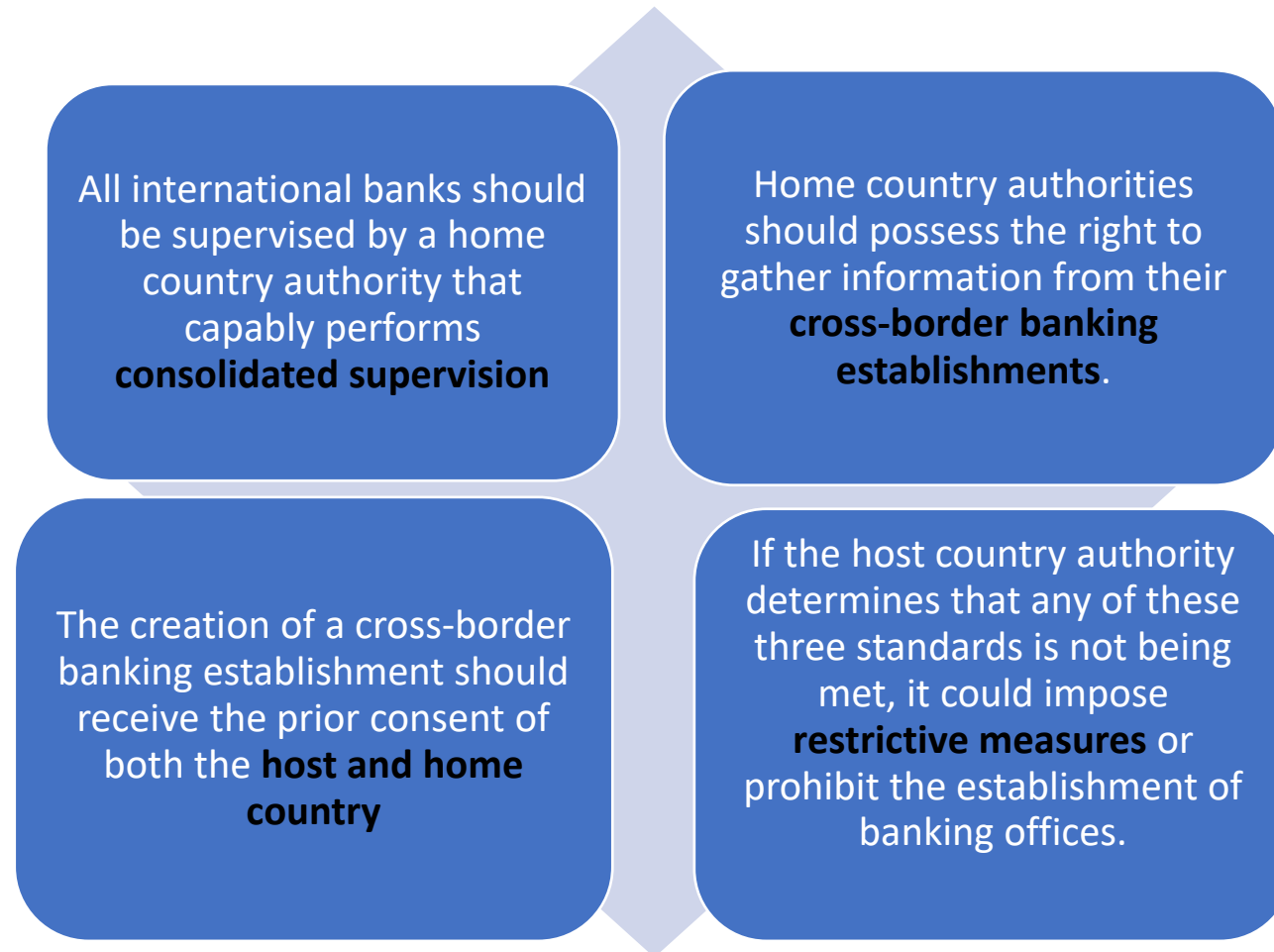
The regulator has to set the amount of **capital which the firm must hold**.



# Home and Host State Regulation

## Basel Concordat on Cross-Border Banking Supervision

The Concordat on Cross-Border Banking Supervision sets out certain principles which the Basel Committee believes should govern the supervision of banks' foreign establishments by parent and host authorities.



## What is Operational Risk?

- A. Risks that affect one firm, or a group of firms, can affect the stability of the whole financial system
- B. Risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.
- c. Risk of loss arising from changes in the value of financial instruments.
- D. Risk is the exposure of a firm's financial condition to adverse movements in interest rates.

EXAM FOCUS



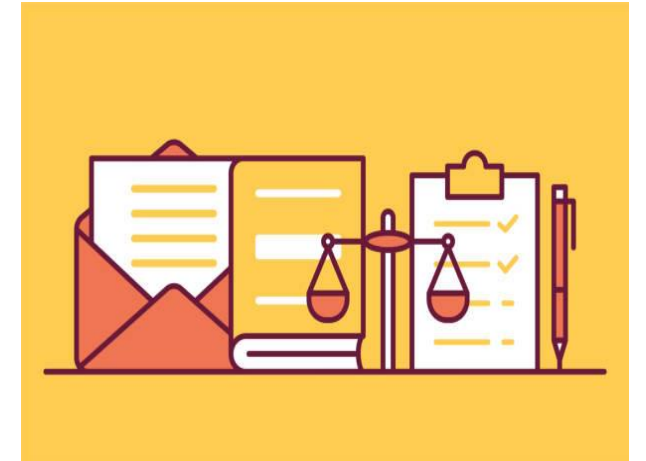
# Principles-Based Regulation - Regulatory Risk

## Regulatory Risk

There are two broad approaches to financial regulation

The '**statutory approach**' is based on specific legal rules which must be obeyed.

The '**principles-based approach**' is to set out in more general terms the types of behaviour that are expected of firms and individuals.

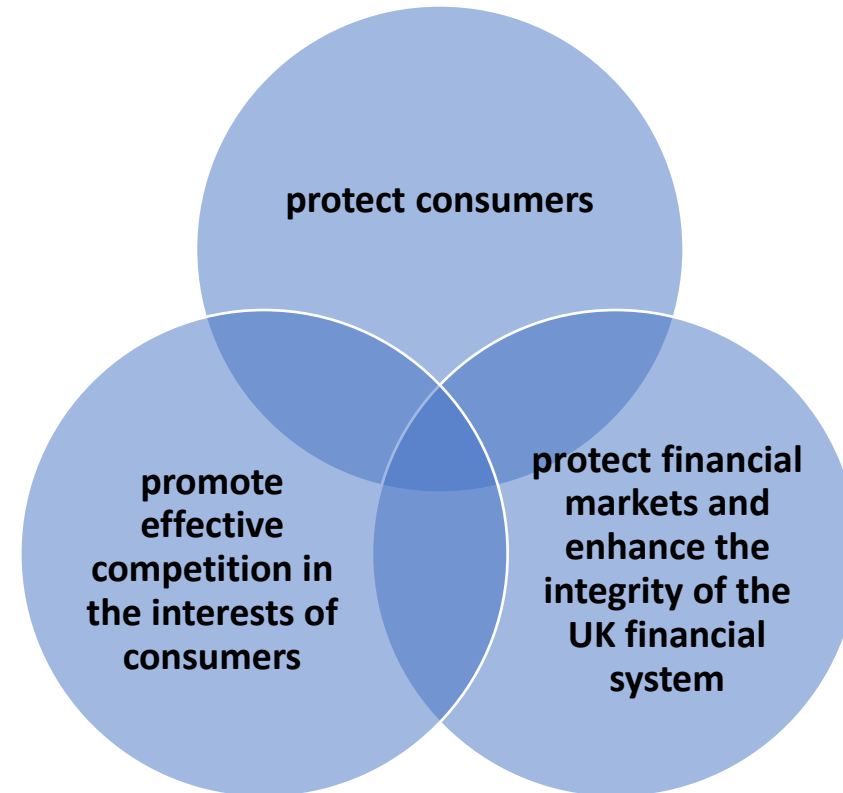


# National Regulator Responsibility

## Supervision Measures to Address Country-Specific Risks

**Supervision** - the process of monitoring them to ensure they are complying with the regulatory requirements.

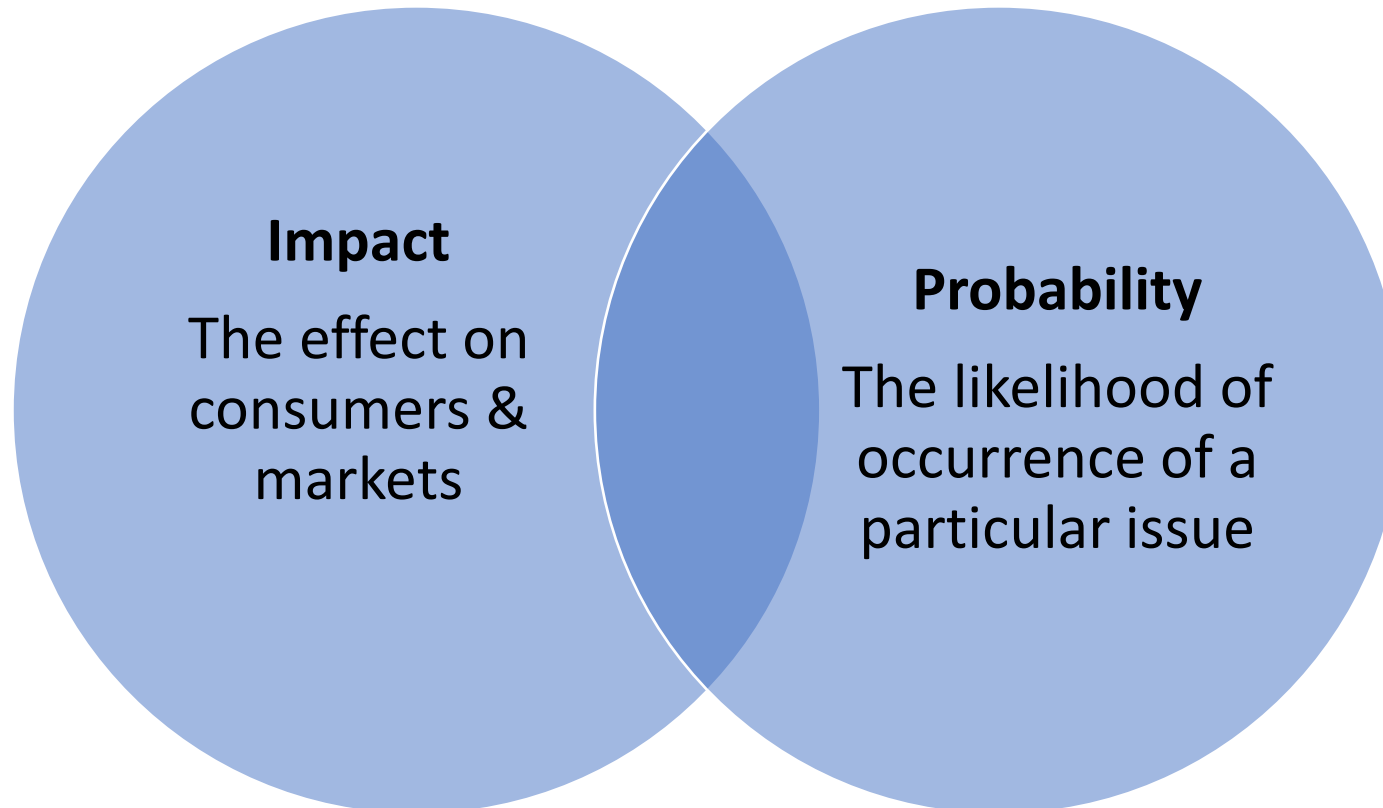
### FCA's three statutory objectives



# National Regulator Responsibility

Firms are supervised according to the risks they present to the regulator's statutory objectives.

The risks are assessed in terms of their:



# Consumer Protection - Risk Management and Control

Consumer protection is an extremely important aspect of financial regulation.

The following are the FCA's 11 'Principles For Businesses'

The first 5 reflect Behaviors & arrangements that **indirectly affect the customers outcomes** -

1. Conduct its business with **integrity**.
2. Conduct its business with due **diligence**.
3. Take reasonable care to organise and control its affairs responsibly with adequate **risk management systems**.
4. Maintain adequate **financial resources**.
5. Observe **proper standards** of market conduct





# Consumer Protection - Risk Management and Control

Consumer protection is an extremely important aspect of financial regulation.

The next 5 reflect Behaviors & arrangements that **directly affect the customers outcomes** -

1. Pay due regard to the **interests of its customers** and treat them fairly.
2. Pay due regard to the information needs of its clients, and **communicate** information to them in a fair and not misleading way.
3. Manage **conflicts of interest fairly**
4. Take care to **ensure the suitability** of its advice and decisions for any customer who rely upon its judgment.
5. Arrange **adequate protection** for clients' assets when it is responsible for them.

And the last one covers the relationship between the firm and its regulator(s)

1. Deal with the regulator in an **open cooperative way**





# Question time

Which of the following behaviors & arrangements indirectly affect the customers outcomes ?

- A. Conduct its business with integrity.
- B. Conduct its business with due diligence.
- C. Maintain adequate financial resources.
- D. All of the above.

**EXAM** FOCUS



## The Senior Managers Regime

The FCA operates a set of targeted behavioural standards called the Senior Managers Regime (SMR)

### Regulatory Standards

#### Supervisory standards include:

Requirements on the provision of **information** that firms need to supply to the regulator

**Rights of access** that a regulator has to each firm that it regulates

The **frequency of** regulatory reviews and risk assessment visits

#### Disciplinary activities include

**Levying fines** for misconduct

Forcing firms to **compensate** customers

Requiring firms to appoint a **third-party expert** at their own expense to investigate issues

Removing a **firm's licence** to operate.



# Regulatory Reviews and Risk Assessment Visits

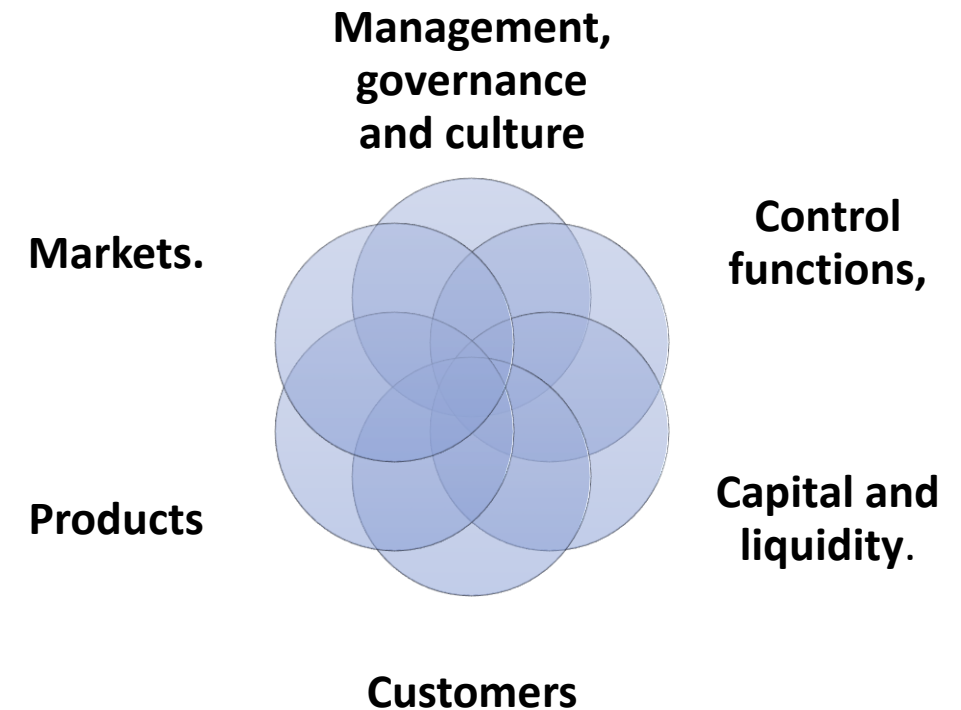
Regulators need know the firms they supervise. The regulator will apply a series of **baseline monitoring activities**.

The regulator needs to assess each authorised firm's:

- **Management, governance and culture**
- **Control functions**
- **Capital and liquidity**

Firms with significant **retail** or **wholesale businesses** , the following areas will also be assessed

- **Customers**
- **Products**
- **Markets**



# Other Relevant Regulation

## Considering other Legislation

If the law is broken by a **firm** or its **staff**, whether **knowingly** or **unknowingly**, there are harmful effects to the firm, in the form of:



Reputational damage



Withdrawal of  
regulatory authorisation  
for certain profitable  
business activities



Fines/penalties



Criminal and civil  
liability



Loss of talented staff  
through dismissal or  
custodial sentence.



# Other Relevant Regulation

Extremely important that firms identify all legislation to which they are, or may be, subject. This is especially true for:

- New start-up firms
- Existing firms launching new business lines
- Existing firms that are setting up overseas offices.



## Considering other Legislation

If the law is broken by a **firm** or its **staff**, whether **knowingly** or **unknowingly**, there are harmful effects to the firm, so it is important that firms identify all legislation.

The risk of inadvertently breaking the law can be mitigated through:

Obtaining professional  
legal advice

Formally  
communicating with  
the regulators

Participating in  
national and  
international industry  
groups

