



FEDERAL RESERVE BANK
OF DALLAS

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DALLAS, TEXAS
75265-5906

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Notice 97-95

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

*Principles for the Management of Interest Rate Risk
and Basle Core Principles for Effective Banking Supervision*

DETAILS

The Basle Committee on Banking Supervision has released *Principles for the Management of Interest Rate Risk*. The document is a revised version of a consultative paper issued in January 1997. It reemphasizes the need for banks to maintain adequate risk management practices in all their activities. In addition, the document identifies specific principles supervisory authorities will consider in evaluating banks' management of interest rate risk.

The Committee has also released the *Basle Core Principles for Effective Banking Supervision*. This document sets out the principles the Committee believes must be in place for a supervisory system to be effective. The principles are intended to serve as a basic reference for supervisory and other public authorities worldwide to apply in the supervision of all the banks within their jurisdiction. Supervisory authorities throughout the world are invited to endorse them by October 1998.

ATTACHMENT

The Basle Committee's press statement regarding core principles is attached.

MORE INFORMATION

For more information, please contact Gayle Teague at (214) 922-6151. For copies of the complete text of the Basle Committee's documents, contact the Public Affairs Department at

For additional copies, bankers and others are encouraged to use one of the following toll-free numbers in contacting the Federal Reserve Bank of Dallas: Dallas Office (800) 333-4460; El Paso Branch *Intrastate* (800) 592-1631, *Interstate* (800) 351-1012; Houston Branch *Intrastate* (800) 392-4162, *Interstate* (800) 221-0363; San Antonio Branch *Intrastate* (800) 292-5810.

(214) 922-5254. The text of both documents is also available on the Bank for International Settlement's Web site at <http://www.bis.org>.

Sincerely yours,

Robert D. McTeer, Jr.

BASLE COMMITTEE ON BANKING SUPERVISION BANK FOR INTERNATIONAL SETTLEMENTS, CH-4002 BASLE

PRESS STATEMENT

The Basle Committee on Banking Supervision, with the endorsement of the central bank Governors of the Group of Ten countries, is today releasing the Basle Core Principles for Effective Banking Supervision. This document, which is a revised version of a consultative paper released in April 1997, establishes a set of twenty-five basic Principles which the Basle Committee believes must be in place for a supervisory system to be effective.

The Basle Core Principles have been drawn up by the Basle Committee in close collaboration with the supervisory authorities in fifteen emerging market countries and have benefited from broad consultation with many other supervisory authorities throughout the world.

The Principles represent the basic elements of an effective supervisory system. They are comprehensive in their coverage, addressing the preconditions for effective banking supervision, licensing and structure, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking.

The Basle Core Principles are intended to serve as a basic reference for supervisory and other public authorities worldwide to apply in the supervision of all the banks within their jurisdictions. Supervisory authorities throughout the world will be invited to endorse the Core Principles, not later than October 1998. Endorsement will include an undertaking to review current supervisory arrangements against the Principles. The speed with which changes can be introduced will vary, depending on whether the supervisory authorities already possess the necessary statutory powers. Where legislative changes are required, national legislators are requested to give urgent consideration to the changes necessary to ensure that the Principles can be applied in all material respects.

The text of the Principles can be obtained from the BIS Web Site on the Internet at <http://www.bis.org> with effect from 23rd September, from national supervisory authorities or from the Basle Committee at the Bank for International Settlements.

22nd September 1997

Notes for editors

1. 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 bank 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.
2. The Basle Committee has been working to improve banking supervision at the international level 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 April 1997 the Committee released two documents:
 - a draft comprehensive set of **Core Principles** for effective banking supervision (The Basle Core Principles); 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, with the endorsement of the G-10 central bank Governors, were submitted to the G-7 and G-10 Finance Ministers in preparation for the Denver Summit in the hope that they would provide a useful mechanism for strengthening financial stability in all countries. They were welcomed by Ministers at the Summit and the Committee was encouraged to continue its work.

3. The document now being issued is a revised version of the April 1997 document. There are still twenty-five Principles and only a few contain changes of substance. Other changes to the document are mostly textual in nature.

4. 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, as well as with the International Monetary Fund and World Bank.

5. The document calls on national agencies to apply the Principles in the supervision of all banking organisations within their jurisdictions. 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 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.

7. 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 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 their work aimed at promoting overall macroeconomic and financial stability.

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

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. The need for new legislation will be taken into account by the Basle Committee in monitoring progress towards implementation.

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.

11. The twenty-five Core Principles are set out below.

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.

22nd September 1997