The Implementation of the Basel Core Principles in Selected Countries from the Perspective of the International Monetary Fund

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This study examines the implementation of the Basel Core Principles (BCPs) based on the Financial System Stability Assessments (FSSAs) carried out by the International Monetary Fund (IMF) in Bulgaria, the Czech Republic, Germany, Croatia, Hungary, Austria, Poland, Romania, Russia, Slovenia, Slovakia and Ukraine. From the perspective of Austria's financial sector, these countries are of particular interest owing to Austrian banks' investment focus on Central and Eastern European countries (CEECs). The 25 Core Principles, which were developed by the Basel Committee on Banking Supervision in 1997, in collaboration with international bank supervisors, the IMF and the World Bank, represent minimum requirements for good banking governance and an efficient supervisory system. The seven supervisory areas examined, to which the BCPs relate, are: preconditions for effective banking supervision, licensing and structure of banks, prudential regulations and requirements, methods of ongoing banking supervision, information requirements, formal powers of supervisors and cross-border banking. By comparing BCP implementation in the relevant countries, the strengths and weaknesses of financial regulation and banking supervision can be identified and a need for action to strengthen the supervisory regime can be inferred.

1 Introduction

Apart from other economic effects, globalization has led to the integration of financial markets, making it possible for crises to spread more quickly and further afield. In the communiqué issued at the Lyon G7 Summit in 1996, the global risks arising from the complex financial sector were highlighted under the heading "Better prudential safeguards in international financial markets" (G7, 1996).

In many cases, weak banking systems lay at the core of these financial crises (Fischer, 1999). One countermeasure is to strengthen both central banking and financial systems. This is why effective and internationally standardized prudential regulations and norms are considered necessary for banks.

2 The Basel Core Principles

In September 1997, the Basel Committee on Banking Supervision (Basel Committee)[2], in collaboration with international banking supervisory authorities[3], prepared a comprehensive set of "core principles for effective banking supervision" (Basel Committee on Banking Supervision, 1997). The International Monetary Fund (IMF) and the World Bank were also involved in developing the Basel Core Principles (BCPs) with the aim of applying them within the framework of their surveillance mandate. In formulating the BCPs, care was taken to ensure that they are applicable not only to industrialized countries but also to transitional and developing countries.

The 25 BCPs are minimum requirements for good banking governance and an efficient supervisory system. They were adopted by the international community at the IMF's annual meeting in October 1997. Although BCP implemen-

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2 *The Basel Committee, which is based at the Bank for International Settlements (BIS), was established by the G-10 in 1974. It comprises the following members: Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. The countries are represented by their respective banking supervisory authorities (central bank or other authority).*

3 *In addition to the Basel Committee member countries, the following countries were directly involved in developing BCPs: Chile, China, the Czech Republic, Hong Kong, Mexico, Russia and Thailand. Furthermore, Argentina, Brazil, Hungary, India, Indonesia, Korea, Malaysia, Poland and Singapore were also associated.*

tation is voluntary, international pressure to comply is significant given the integration of financial markets. Since BCPs are defined as minimum standards, it is a matter for individual countries to stipulate individually tailored requirements – in addition to the BCPs – for the purpose of covering specific risks and to incorporate sufficient flexibility into their legislative framework in order to satisfy ever-changing market conditions.

The Basel Core Principles are summarized in table 1.

Table 1

Basel Core Principles

BCP 1	Preconditions of effective banking supervision
BCPs 2–5	Licensing and structure
BCPs 6–15	Prudential regulations and requirements
BCPs 16–20	Methods of ongoing banking supervision
BCP 21	Information requirements
BCP 22	Formal powers of supervisors
BCPs 23–25	Cross-border banking

Source: Basel Committee.

The definition of the BCPs includes the following principles (Basel Committee on Banking Supervision, 1997):

1. The key objective of banking supervision is to maintain stability and confidence in the financial system, thereby minimizing the risk of loss to depositors and other creditors.
2. Bank supervisors should support market discipline and enhance market transparency by highlighting and promoting sound corporate governance structures.
3. In order to carry out its tasks effectively, a supervisory authority must have operational independence, the means and powers to gather information both on and off site, and the authority to enforce its decisions.
4. Supervisory authorities 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. Banking supervision cannot, and should not, provide an assurance that banks will not fail.
5. Effective banking supervision requires that the risk profile of individual banks be analyzed and supervisory resources allocated accordingly.
6. Supervisors must ensure that banks have appropriate resources to undertake risks, including adequate capital, sound management, and accounting records in compliance with international standards.
7. Close cooperation and the exchange of information with international supervisory agencies are essential.

3 The Application of BCPs by the IMF

The role of international financial institutions such as the IMF is, inter alia, to provide support to member countries and to strengthen their economic and financial systems. Owing to their integration of economic and financial policies and to their surveillance expertise, the IMF and the World Bank are actively involved in the implementation process, as the Basel Committee has neither the competence nor the staff to monitor BCP implementation.

The Financial Sector Assessment Program (FSAP) was jointly created by the IMF and the World Bank in May 1999 in order to enhance the effectiveness of member countries' financial systems, i.e. to reduce the financial sector's vulnerability while promoting its development and contributing to improving economic growth. Participation in the program is on a voluntary basis.

Under the FSAP, IMF and World Bank experts, supported by supervisory authorities and central banks[4], perform Financial System Stability Assessments (FSSAs) to evaluate the stability of the financial sector by monitoring the relevant standards in the banking, insurance and securities sectors.

Using the methodology of the Basel Committee, they assess BCP compliance in the banking sector, analyze weaknesses in the financial system and develop relevant remedial measures and recommendations. This study will focus solely on the banking sector and its implementation of BCPs.

Originally planned as a pilot project with 12 countries, the FSAP was extended to cover more than 80 countries by the end of 2004 (see annex 1). This was not only due to the wave of international approval but, above all, to the fact that FSSAs were directly helping to uncover emerging problems in some countries and to develop a raft of national reforms. More generally, they also raised the IMF's surveillance work and the World Bank's development activities in the financial sector to a new level. Despite the huge response elicited by the FSAP from the IMF's 185 member countries, a survey of global financial stability was not forthcoming owing to, among other factors, the lack of FSAPs for systemically important countries such as the U.S.A. and China.

Under the FSAP, the IMF's general procedure for assessing BCPs commences with the relevant country performing a self-assessment based on several questionnaires sent by the IMF and with the production of all relevant documentation. Subsequently, a small group of experts, consisting of IMF representatives and selected supervisory authorities, confers on site with the home country banking supervisor to discuss any difficulties encountered in implementing the BCPs. Finally, the group of experts prepares an assessment report, which should also include a trouble-shooting plan. If the country assessed gives green light, its assessment report is published on the IMF's website.

This study examines BCP implementation based on the FSSAs carried out in selected countries. From the perspective of Austria's financial sector, countries in which Austrian banks have invested heavily are of particular interest. This study therefore presents an overview of the IMF's assessment results on BCP compliance for Bulgaria, the Czech Republic, Germany, Croatia, Hungary, Austria, Poland, Romania, Russia, Slovenia, Slovakia and Ukraine.

The sources used were the FSSAs of selected countries, which were published by the IMF until June 2005. It must be said that these FSSAs lack the necessary degree of detail for an accurate analysis due to the IMF's practice of confidentiality. Moreover, FSSAs are supposed to avoid any description that is damaging to the relevant financial market. Since FSSAs are not conducted every year and as there are no recent updates for certain countries, Article IV Consultations, which are carried out annually by the IMF, and/or the latest

4 *Including the OeNB.*

Reports on the Observance of Standards and Codes (ROSCs) of certain countries are used to obtain a more up-to-date overview of the progress of BCP implementation.

4 General Findings Regarding BCP Compliance

The methodology of the Basel Committee establishes five assessment categories: compliant, largely compliant, materially non-compliant, non-compliant and not applicable.

The assessment criteria of individual BCPs consist of criteria that are absolutely essential for full compliance as well as additional criteria. Despite this specified categorization, the IMF still has relatively wide-ranging discretionary powers as regards the assessment of BCP compliance.

The IMF's most recent general survey to date on BCP compliance dates from 2002. It presents a summary of BCP compliance in 60 countries that had undergone assessment by December 2001 (International Monetary Fund and World Bank, 2002). The findings of this IMF study show that 32 of the 60 countries were fully compliant with 10 or fewer of the 25 BCPs. Only 10 countries were compliant with 20 or more BCPs. Developing countries generally showed lower levels of compliance than industrialized countries, although this was due to, inter alia, adverse macroeconomic conditions, an inadequate legal and judicial system, poor credit control and inaccurate accounting systems. Although some of these weaknesses relate to areas outside the jurisdiction of banking supervision, remedying them is an essential precondition for effective banking supervision. Stable macroeconomic conditions support the resilience of the financial sector. Although banking supervision has been relatively well established and organized, it still fails to promptly bring supervisory requirements in line with the dynamic developments of the financial market. The key requirements were consolidated supervision, adequate risk evaluation by oversight and cross-border cooperation between supervisory authorities. Banking supervision in industrialized countries also faced challenges. In particular, the rise of international financial conglomerates and the development of new financial instruments and derivative products require constant fine-tuning of supervisory methods relating to both sector-wide and cross-border risk management.

5 The Results of FSSAs in Selected Countries

5.1 BCP 1: Preconditions for Effective Banking Supervision

The preconditions for effective banking supervision cited by the Basel Committee are sound and stable economic policies, a well-developed public infrastructure, effective market discipline, procedures for efficient trouble-shooting in banks and mechanisms for providing an appropriate level of systemic protection (or a public safety net). This means that clear responsibilities and standards are required for banking supervision. The supervisor should be provided with the necessary independence, the appropriate powers and adequate resources to exercise its mandate and should be embedded in an appropriate legal framework. Banking supervision should enjoy protection from both personal and institutional liability, provided its supervisory function is performed in good faith. A system of cooperation and information exchange between the various domestic and foreign supervisory authorities, as well as precautionary measures against the exchange of confidential information, should be in place.

Almost half of the 60 countries assessed by the IMF by the end of 2001 for BCP implementation and compliance had fulfilled most BCP 1 criteria and had created a framework for effective banking supervision. It is worth highlighting that some 40% of countries found it hard to comply with the principle of supervisory independence (BCP 1.2). A further weakness was the legal protection of supervisors (BCP 1.5), and the exchange of information between banking authorities and other supervisory agencies both domestically and internationally (BCP 1.6) (see annex 2).

In the ROSC updated in 2004, the IMF noted that *Croatia* was the only one of the countries examined in this study to have complied with every recommendation of the FSSA of 2002. Accession to the EU in 2004 meant that *Poland, Slovakia, Slovenia,* the *Czech Republic* and *Hungary* had to bring their banking supervision's legislative and regulatory frameworks into line with EU norms. This resulted in a higher BCP implementation and compliance rate. However, the IMF points out – not least in view of the financial sector's ever-increasing complexity, growing competition and narrowing bank margins – that the implementation and application of banking supervisory norms is not a matter of mere statistics but requires ongoing efforts to meet these additional demands.

In *Germany, Austria, Poland* and *Hungary,* political influence exerted on the relevant supervisory authority is currently being examined by the IMF. In *Austria,* moreover, the IMF is examining the problem of liability faced by financial market supervision in the event of a bank insolvency. According to the IMF, the role of banking supervision is to ensure the orderly liquidation of weak banks but not to prevent all losses and insolvencies. In *Poland* and *Slovenia,* clear conditions are also necessary as regards the legal protection of employees. In *Romania,* although bank supervisors are legally protected in exercising their mandate, there is no legal protection against costs incurred by proceedings. In *Ukraine,* legal protection should be introduced for external staff insourced for assessments.

In *Poland, Slovakia* and in *Slovenia,* banking supervision needs to be provided with better financial and staff resources in order to meet assessment requirements.

In *Hungary,* although the Hungarian Financial Supervision Authority (HFSA) is responsible for issuing and withdrawing banking licenses, it is obliged to consult the country's central bank prior to withdrawing a license. Although the HFSA can issue only nonbinding guidelines and recommendations for the country's financial sector, individual bank assessment decisions are binding.

In the *Czech Republic,* insolvency law relating to the liquidation of banks is inadequate. The Czech judiciary is considered to be unsatisfactorily short-staffed and slow.

In *Bulgaria,* although the Bank Insolvency Act was adapted under the FSAP in the fall of 2002 on the advice of the IMF, its implementation has so far been slow and still awaits assessment.

Reform of the banking sector is of the highest priority in *Russia*. The IMF's general conclusion is that the practical implementation of largely sufficiently current statutory provisions is inadequate. Many laws overlap with each other and subsequent secondary legislation is often absent. As a supervisory authority, the Russian central bank therefore needs to adopt a broad-based strategy designed to strengthen the supervisory environment, to ensure greater transparency of the ownership structure in banks, to improve the reporting system, to consolidate the fragmented private banking sector and to standardize conditions for both private and state-owned banks.

5.2 BCPs 2–5: Licensing and Structure

BCPs 2–5 stipulate that, in addition to the definition of the term "bank" by the supervisory authority, the ownership structure, directors and senior management (assessment of competence, integrity and expertise, i.e. fit and proper criteria), operating plan, internal control systems and capital base must be presented to the supervisory authority as a minimum requirement for the licensing of banks. Where a foreign bank is involved, the consent of its home country supervisor should be obtained before licensing. The supervisory authority should be notified if any changes to the original licensing are made in terms of the ownership structure. Similarly, the supervisory authority must have the power to specify criteria for acquisitions and investments in order to prevent unnecessary risks from being incurred.

As regards a bank's licensed activities, the Banking Act of *Slovakia* does not provide for the intervention of banking supervision where an institution is carrying out banking transactions without a banking license. New banks should therefore be monitored more frequently. In addition to banks, credit associations in *Romania* should be subject to appropriate surveillance by the country's central bank. To date, Banca Națională a României, the Romanian central bank, does not consult the home country authority before licensing foreign subsidiaries or before the acquisition of Romanian banks by foreigners. The planned amendment to the law will be confined to EU countries. In the *Czech Republic,* the licensing procedure for identifying the lawful owner of a bank should be improved.

Russia should have more stringent measures as regards "fit and proper" provisions for banking management.

In Russia and *Ukraine* the Banking Act should contain provisions that give banking supervision sufficient powers to ensure the disclosure of the ownership structures of banks. In *Ukraine,* the power of banking supervision to reject owners should also be introduced.

According to the IMF, *Germany, Austria* and *Romania* should have more stringent provisions regarding the prenotification of major or risky acquisitions by banks. This applies particularly to investments in entities other than credit institutions. The supervisory authorities in these countries should also be involved in the decision-making process at an earlier stage.

5.3 BCPs 6–15: Prudential Regulations and Requirements

According to the Basel Committee, supervisory authorities play a key role in monitoring the risks inherent in the banking system. The development and control of qualitative and quantitative criteria for managing appropriate capital adequacy, credit risk, the assessment of asset quality and loan loss provisions and reserves, portfolio diversification, connected lending, country and transfer risks, market risk and all other risks (interest rate risk, liquidity risk, operational risk) are indispensable. Banking supervision must also ensure that adequate internal control systems are in place and that stringent "know-your-customer" rules are applied so that high professional standards in the financial sector are promoted and protection is guaranteed against the abuse of the banking system by criminal elements. In particular, supervisory authorities should support the implementation of recommendations made by the Financial Action Task Force on Money Laundering (FATF), where these apply to financial institutions.

Some 40% of the 60 countries analyzed by the IMF until 2001 reveal shortcomings in their compliance with BCPs 7 (credit policies) and 10 (connected lending), and 30% in their compliance with BCP 8 (loan evaluation). Credit risk, particularly as a result of connected lending, poor risk management, lax credit classification and the generous acceptance of collateral, represented some of the threats to a sound banking system. Almost half of the countries found it hard to comply with BCPs 11–13, which relate to risk management. In many countries where foreign investment by banks is not a common phenomenon, country risk is considered to be insignificant for this very reason. Nevertheless, banking supervision should acquire the competence to assess country risk, market risk, operational risk and, above all, liquidity risk. About half the countries assessed revealed shortcomings in complying with BCP 15 (the "know-your-customer" rule). According to the IMF, this gives cause for alarm as regards anti-money laundering measures. A further weakness in some 30% of the countries was the inaccurate calculation of the appropriate level of capital adequacy. At times, this calculation included only credit risk (see annex 2).

In *Austria, Germany, Poland, Slovakia, Slovenia, Russia, Ukraine* and *Hungary*[5], the guidelines on the extension and management of loans to related companies or individuals should be more precisely defined, according to the IMF. Česká národní banka, the central bank of the *Czech Republic,* should be given greater discretionary powers to interpret the definition of "related companies and individuals." In *Russia,* the definition of "insider" should include at the very least companies that belong to the "insider" or are controlled by said party.

The IMF recommended *Slovenia* to improve loan evaluation in respect of its banking groups' significant level of outstanding loans. The IMF urged *Germany* to define and report both bad loans and those to be restructured more precisely. In *Ukraine,* lending, in respect of total lending and risk assessment, should be legally defined in detail and implemented.

[5] *The HFSA bases itself on consistency with EU Directives and therefore refuses to adapt the guidelines on connected lending.*

The *Czech Republic* is characterized by poor legal definition and inadequate supervisory support for banks in terms of the application of the "know-your-customer" rule. According to the IMF, this could give rise to stringent lending conditions that will adversely affect the legal enforceability of loan agreements and undermine anti-money laundering measures. In *Russia,* the central bank should monitor banks' hitherto patchy compliance with money laundering guidelines more strictly and penalize any violations thereof.

According to the IMF, *Bulgarian* and *Romanian* banking supervision should also provide support to individual institutions in managing country risk and monitoring related management practices. Bulgarian banking supervision should include in its plans staff for monitoring interest rate risk, market risk, risk management systems and IT systems. In *Ukraine,* by contrast, the central bank has yet to formulate guidelines on country risk, market risk and interest rate risk. In *Poland,* banks should pay closer attention to both country and market risk, and banking supervision should improve guidelines. Likewise, both *Germany* and *Austria* need to prepare clearer guidelines on the correct management of liquidity risk, interest rate risk and operational risk. As regards operational risk, the IMF thinks that the *Czech Republic* should make further adjustments to its Banking Act.

The IMF also criticizes *Bulgaria, Romania, Russia, Slovakia* and *Ukraine* for failing to include market risk in capital adequacy and to calculate capital adequacy on a consolidated basis.[6,7] In view of both macroeconomic and internal bank risks (poor credit management and loan portfolio), the IMF recommends *Ukraine* to increase minimum capital adequacy to at least 10%.

According to the IMF, *Russia* should improve its accounting standards so that capital ratios can be calculated more accurately. Guidelines on lending and investment criteria remain to be drafted.

In *Bulgaria, Poland, Russia, Slovenia* and *Hungary,* the responsibility and liability of bank management should be clearly defined (corporate governance). The IMF urges banking supervisors in *Hungary* to pay greater attention to internal control systems in banks and not only monitor compliance with formal guidelines. In *Russia,* furthermore, companies' internal audit reports should be submitted to the supervisory board at least twice a year.

5.4 BCPs 16–21: Methods of Ongoing Banking Supervision and Information Requirements

An effective system of banking supervision should consist of both on-site inspections and off-site analyses. Bank supervisors should maintain contact with the directors and senior management of banks at regular intervals, as well as collect and analyze (consolidated supervision) information on the activities of these banks (in particular, non-core activities) and their domestic and foreign branches. On-site inspections test, inter alia, validated information for plausibility. Bank supervisors must ensure that accounting records are in line with general accounting principles and rules. Banks must regularly file up-to-date financial statements and balance sheets. If a bank knowingly or through

6 *Planned for 2004 in Bulgaria.*

7 *In Slovakia this should have been taken into account in the implementation of the capital adequacy guideline, which was planned for 2004.*

want of care provides bank supervisors with incorrect data, the banking supervisor must take appropriate supervisory steps and/or initiate criminal proceedings forthwith.

More than half of the 60 countries assessed by the IMF until 2001 revealed shortcomings in consolidated supervision (BCP 20). Similar weaknesses were to be found in global supervision in most countries (BCP 23). In view of the rise of financial conglomerates with cross-border operational activities, both the legal and operational implementation of global consolidated supervision is indispensable, according to the IMF (see annex 2).

In *Germany* and *Austria,* the current frequency of on-site inspections could be increased. In Austria this would require greater resources. In Germany, off-site analysis should also be systematized. In *Slovenia* as well, the requisite frequency of inspection cannot be complied with due to staff shortages. This is why it should fully exploit synergies with external auditors. In *Ukraine,* moreover, the frequency of inspections should be increased and the quality of the work by external auditors enhanced. *Russia* should rethink its supervisory methods to enhance the quality of examination. Its current focus consists in fulfilling the formal conditions rather than in evaluating underlying risks. Likewise, an approach that is more risk-aware is required for bank supervision in *Ukraine.*

As for consolidated supervision, *Bulgaria* has a special regulation, according to which subsidiaries in countries where the transfer of information is impeded by legal obstacles are exempted from reporting on a consolidated basis. This regulation should be revised.[8] *Germany* should extend consolidated supervision to both nonconsolidated and holding companies. In *Russia,* legislation governing the exchange of consolidated information should be enacted to facilitate risk management within a corporate group. In *Slovenia,* provision should be made for the systematic risk evaluation of activities constituting non-core business. In *Poland*[9] and *Ukraine*[10], supervision on a consolidated basis is nonexistent, according to the IMF.

The layout of the annual report based on international accounting standards (IAS) has yet to be developed in Ukraine. In *Russia,* banking supervision should request that reports be based on IAS. The filing of information by non-exchange listed banks should be expedited in *Hungary.*

5.5 BCP 22: Formal Powers of Supervisors

Supervisory authorities must have at their disposal adequate supervisory instruments to bring about timely corrective action when banks fail to meet prudential requirements or where depositors are at risk in any other way. Assessing whether a bank can be restructured is also important, as is the proposal of appropriate remedial measures. In the worst-case scenario, it should be possible to withdraw the banking license.

[8] *Although this regulation is in line with the EU Directive, as Bulgaria is (still) not an EU Member State, this special regulation was criticized by the IMF.*

[9] *Assessment on a consolidated basis is current supervisory practice.*

[10] *Compliance with BCP 20 was planned by the National Bank of Ukraine in 2003.*

In somewhat more than 40% of the countries assessed by the IMF by the end of 2001, bank supervisors lacked independence[11] or legal protection, and supervisory measures were not protected under law (see annex 2).

In *Austria,* the IMF sees the burden of proof placed on the banking supervisor as problematic, as an (excessively) lengthy period of time could elapse before steps are taken to prevent bank supervisors from facing legal action[12] (claim for compensation).

In *Russia,* supervisory authorities should have the power to make bank managers liable. The explicit and increased enforceability of remedial measures should be enshrined within *Czech* law. Generally, supervisory measures and compliance therewith should be monitored and improved in *Poland.*

5.6 BCPs 23–25: Cross-Border Banking

As part of their mandate of consolidated supervision, home country bank supervisors have a twofold obligation. First, they must monitor internationally active banks' compliance with prudential regulations, a key component of which is establishing regular contact and information exchange with host country supervisory authorities. Second, they must ensure that the same prudential regulations apply to foreign banks as they would to domestic banks.

In concert with *Germany, Slovakia, Slovenia,* the *Czech Republic* and *Hungary, Austria* has signed a Memorandum of Understanding (MoU) on cooperation between supervisory authorities.[13] The MoU with *Croatia* was concluded in June 2005. Further MoUs are currently being negotiated with Poland and Romania.

In *Germany,* the Federal Financial Supervisory Authority (BaFin) should prohibit the licensing of foreign branches where cooperation with the competent home country supervisory authority is not guaranteed.

Information exchange with foreign supervisory authorities should be stepped up in *Poland.* Currently, the transfer of information from foreign subsidiaries and Polish bank branches is only on a voluntary basis. Although the supervisory authority may prohibit the opening of branches, it may not make them close down.

Although, in *Romania,* the results of foreign branches are included in Romanian banks' financial statements, the results of foreign subsidiaries and joint ventures should be consolidated. Although Banca Naţională a României can close down the foreign branches of Romanian banks, it cannot keep the latter from pursuing their various international activities. Financial statements filed by foreign branches in Romania should not be confined to including merely the balance sheet, income statement and outstanding foreign currency loans.

In *Slovenia,* further specialist training for bank supervisory staff would be recommendable for comprehensive global consolidated supervision.

[11] *Although the independence of bank supervisors only relates to BCP 1, FSSAs frequently deal with BCP 1 and BCP 22 jointly, as these principles are closely associated.*

[12] *However, no such case is known to date.*

[13] *In addition to the above-mentioned countries, Austria has concluded MoUs with France, Italy, the United Kingdom and the Netherlands. It is currently negotiating an MoU with Bulgaria. However, this has yet to be concluded, contrary to the representation in the IMF's 2002 FSSA (International Monetary Fund, 2002a, 40).*

In *Russia,* the central bank should have the right to exchange customer information with domestic and foreign authorities in respect of their outstanding debts.

In *Hungary,* consolidated supervision should also focus on Hungarian banks with foreign representative offices.

Ukraine should generally step up information exchange with foreign supervisory authorities. Ukrainian banks require their central bank's written permission in order to open a foreign branch. A further restriction is the fact that this applies only to countries with which Ukraine has an MoU. As for foreign banks, they can only open subsidiaries – and not branches – in Ukraine.

6 Key BCP Assessment Results of Selected Regional Groups

The common problems shared by certain regional groups considered in this study – old EU Member States, new EU Member States and nonmember states – are summarized here, taking into account the diversity of the results and the different times at which individual FSSAs and their updates were prepared (see annex 3). It should be remembered that BCP implementation is the minimum requirement for effective banking supervision; the expectation in industrialized countries, in particular, is that the process of improving implementation will maintain its momentum, with banking supervision constantly bringing itself in line with market requirements.

The FSSAs for Austria and Germany show that banking supervision in these two countries is embedded in a well-developed legal framework of long standing. This guarantees not only close cooperation between individual supervisory authorities but also ensures their independence. Although compliance with BCPs is generally high, improvements can be made in the domains of financial conglomerate supervision and risk management by banks. The banking sector's market discipline could definitely benefit from increased transparency and disclosure. Although the supervisory authorities are relatively small and rather poorly staffed, the high quality of their on-site inspections is conspicuous. Their staff shortages are only partly offset by their focus on systemically important institutions and by their inclusion of external auditors. According to the IMF, banking supervision in Austria and Germany is equal to facing the challenges posed by the sector-wide and cross-border integration of financial markets and the rapid development of new financial instruments.

Despite general adjustments to legislation in the areas of banking, the law and insolvency as a result of EU accession by Poland, Slovakia, Slovenia, the Czech Republic and Hungary, these countries' shared shortcomings have to do with their compliance with the requirements for covering credit risks and global consolidated supervision, according to the IMF.

The remaining countries considered in this study can be classified into two groups. According to the IMF, Croatia has complied with every BCP. In Bulgaria, Romania, Russia and Ukraine, by contrast, the need for reform is to be found primarily in contract law and creditor protection. On the operational front, these countries need to catch up in terms of ongoing supervision – particularly, in the identification of potential weaknesses. Above all, criticism is directed at the qualitative assessment of banks, their managerial practices and their risk management. Also evident are the authorities' partial shortcomings in enforcing the law. Although both consolidated and cross-border supervision reveal weaknesses (generally on staffing grounds), they are currently in the process of being developed in all the countries under review.

7 Conclusions

By assessing the implementation of the Basel Core Principles within the framework of the FSAP, the IMF can make two valuable contributions. First, it can take stock of the efficiency with which banking supervision is conducted in individual countries and, second, it can ensure global financial stability. By comparing the implementation of BCPs in the countries concerned, the strengths and weaknesses of both financial regulation and banking supervision can be identified and the need for action to strengthen the supervisory regime can be inferred. Adherence to and convergence with international standards, together with technical assistance provided by the IMF, should promote the certainty of law and confidence in the banking sector. This can be clearly seen in Croatia's case. Its banking supervision problems, identified by the IMF in the FSSA of 2002, were remedied by the Croatian authorities' measures recommended by the IMF. As a result, the ROSC in 2004 did not contain any criticism of BCP implementation.

The FSAP findings showed that efficient bank supervision and full BCP implementation are possible only if economic policies are stable and the legal system is well developed. It can also be noted that BCP implementation could be improved in many domains. This primarily relates to BCPs governing general credit policies and connected lending, as inadequate credit management is by far the greatest danger for the sector's stability. In this respect, there is frequently a discrepancy between current formal guidelines on loan evaluation and lending, and the practical implementation thereof. The potential significance of country risk, market risk and all other risks (interest rate risk, liquidity risk and operational risk) as well as the ability of bank supervisors to identify these is often underestimated, as these types of risk currently still lack any real meaning for many countries. A further challenge for banking supervision is the assessment of increasingly larger and more complex financial conglomerates on a consolidated basis.

However, this study has also shown that the various IMF assessment teams still have relative discretionary powers in interpreting BCP compliance. If the FSSA report results were clearly and uniformly assigned to the Basel Committee's assessment categories, this would facilitate the comparison of BCP compliance in individual countries. The assessment reports should be prepared in a way such that comparability and transparency are guaranteed. However, a certain qualification needs to be made. Owing to the confidentiality of the detailed FSAP reports, some of the FSSAs published are only in a cursory summary form, which could make comparison difficult. In addition, it is even more difficult to make direct comparisons, as critical appraisals in FSSAs are often problematic country-specific issues proposed by supervisory authorities, some of which go beyond BCP compliance in the strict sense of the word.

Reports prepared within the FSAP framework are at times very complex and are seldom used as a decision-making basis by market players in practice. However, the assessment categories in the methodology of the Basel Committee need to be worded more precisely. The question also arises as to the differentiated assessment of industrialized countries and developing countries.

Follow-up by the IMF at regular intervals would also be desirable in order to monitor the implementation of recommended measures in certain countries and the banking sector's further progress. At present, there is no provision for FSSA updates. Irregular and fairly infrequent FSSA updates are often attributable to inadequate resources at the IMF. Although BCP assessments can also be performed under Article IV Consultations and/or ROSCs, they are not performed to the same degree of detail as FSSAs.

The accession of Poland, Slovakia, Slovenia, the Czech Republic and Hungary to the EU as well as the preparations made by Bulgaria, Croatia and Romania in the run-up to accession have accelerated the implementation of BCPs in these countries. However, as the IMF repeatedly points out, BCPs are only minimum standards and it is the responsibility of individual countries to specify and fine-tune individually tailored conditions for sound effective banking supervision.

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Annex 1

Status of FSAP Projects[1])

2000	2001	2002	2003	2004	2005
Columbia	Ghana	Gabon	Kirghiz Republic	Macedonia	*Belarus*
Lebanon	Guatemala	Switzerland	Japan	Jordan	*Sudan*
Canada	Poland	Lithuania	Bangladesh	Kuwait	*Norway*
South Africa	Armenia	Luxembourg	Hong Kong	New Zealand	*Belgium*
El Salvador	Israel	Sweden	Honduras	*Kenya*	*Italy*
Hungary	Peru	Philippines	Malta	ECCU[2])	*Paraguay*
Iran	Yemen	Korea	Mauritius	*Ecuador*	*Rwanda*
Kazakhstan	Senegal	Costa Rica	Singapore	Azerbaijan	*Serbia*
Ireland	Slovenia	Bulgaria	Oman	Austria	*Albania*
Cameroon	Iceland	Sri Lanka	Germany	Netherlands	*Jamaica*
Estonia	Czech Republic	Morocco	Mozambique	*Nicaragua*	*Trinidad, Tobago*
India	Uganda	Nigeria	Tanzania	Chile	*Bahrain*
	Dominican Republic	United Kingdom	Romania	Saudi Arabia	*Spain*
	United Arab Emirates	Slovakia	Algeria	France	
	Latvia	Barbados	Bolivia	*Pakistan*	
	Tunisia	Brazil		*Moldova*	
	Finland	Ukraine			
	Mexico	Russia			
	Croatia	Egypt			
	Georgia	Zambia			
FSAP Updates					
	Lebanon	Hungary	Iceland	Ghana	Senegal
	South Africa			Slovenia	Hungary
				Kazakhstan	Columbia
				El Salvador	Uganda
					Nigeria

Source: IMF.
[1]) *Current and planned FSAPs in italics.*
[2]) *Eastern Carribean Currency Union.*

Annex 2

Compliance with BCPs

% of all countries assessed by the IMF, where applicable

Basel Core Principles for Effective Banking Supervision	Compliant or largely compliant	Non-compliant or insufficiently compliant	Assignment of compliance problems recorded in section 5 to countries assessed[1])	Problems identified by the IMF
1. Framework for supervisory authority				
1.1 Objectives	89	11		Shared responsibility; unclear role of external auditors
1.2 Independence	61	39	AT, DE, HU, PL, SK, SI	Political influence; insufficiently enshrined in law; not enough qualified personnel
1.3 Legal framework	90	10	BG, CZ, RU	Poor information exchange; inadequate cooperation (also with foreign authorities); insolvency law; inadequate compliance
1.4 Enforcement powers	80	19		Inadequate legal framework
1.5 Legal protection	71	29	PL, RO, SI, UA	Inadequate legal protection of supervisors; outstanding liability issues
1.6 Information sharing	71	29		Lack of formal basis
2. Permissible activities	94	6	CZ, RO, SK	Unclear licensing criteria
3. Licensing criteria	84	16	RU	Political influence; lack of bank management requirements
4. Ownership	82	18	RO, RU, UA,	Too little transparency of ownership structure
5. Investment criteria	75	25	AT, DE, RO	Lack of restrictions on investments
6. Capital adequacy	67	33	BG, RU, RO, SK, UA,	No risk-weighted calculation of capital adequacy
7. Credit policies	66	34	RU	Unclear specifications
8. Loan evaluation	68	32	DE, RU	Unclear rules
9. Large exposures	74	26	PL, RU, SI, UA,	No monitoring on a consolidated basis
10. Connected lending	59	41	AT, DE, CZ, PL, RU, SI, SK, HU	Inadequate legal framework
11. Country risk	38	48	BG, PL, UA,	Lack of rules
12. Market risk	46	51	BG, PL, RO, UA	Lack of rules
13. Other risks	51	49	AT, CZ, BG, DE, UA	Lack of rules; insufficient supervisory staff numbers
14. Internal control	66	34	BG, HU, PL, RU, SI	Lack of standards; no corporate governance rules
15. Money laundering	55	45	AT, CZ	Lack of legal framework
16. Framework for on-site and off-site supervision	73	27	AT, SI, UA, RU	Low frequency of supervision; small, poorly educated staff; unclear specifications
17. Bank management	83	17		Poor contact management
18. Requirements for off-site supervision	74	26		No consolidated supervision
19. Validation of information	77	23		No steps taken to remedy poor external audit
20. Consolidated supervision	39	45	AT, BG, DE, PL, RU, SI, UA	Lack of specifications
21. Accounting	73	27	HU, UA	No compliance with IAS; lack of enforceability
22. Remedial measures	65	35	CZ, HU, PL, RU	Inadequate legal framework; ineffective compliance
23. Global consolidation	47	25	HU, PL, RU, RO, SI, UA	Lack of consolidated supervision; insufficient competence to monitor foreign institutions; poor information exchange
24. Host country supervision	58	23	DE	Lack of formal agreement with home country authorities
25. Supervision of foreign establishments	77	20	RO	Inadequate information exchange; no supervision permission for foreign authorities

Source: IMF.

[1]) See Legend, Abbreviations and Definitions for a list of country codes.

Annex 3

BCP Implementation Problems and Areas of Improvement in Selected Countries

Basel Core Principles for Effective Banking Supervision	AT[1])	BG	HR	CZ	DE	HU	PL	RO	RU	SI	SK	UA
1. Framework for supervisory authority												
1.1 Objectives												
1.2 Independence	●				●	●	●			●	●	
1.3 Legal framework		●		●					●			
1.4 Enforcement powers												
1.5 Legal protection							●	●		●		●
1.6 Information sharing												
2. Permissible activities				●				●			●	
3. Licensing criteria						●		●				
4. Ownership								●	●			●
5. Investment criteria	●				●			●				
6. Capital adequacy		●						●	●		●	●
7. Credit policies									●			
8. Loan evaluation					●				●			
9. Large exposures							●		●	●		●
10. Connected lending	●			●	●	●	●		●	●	●	
11. Country risk		●					●					●
12. Market risk		●					●	●				●
13. Other risks	●	●		●	●							●
14. Internal control		●				●	●		●	●		
15. Money laundering	●			●								
16. Framework for on-site and off-site supervision	●								●	●		●
17. Bank management												
18. Requirements for off-site supervision												
19. Validation of information												
20. Consolidated supervision	●	●			●		●		●	●		●
21. Accounting						●						●
22. Remedial measures				●		●	●		●			
23. Global consolidation						●	●	●	●	●		●
24. Host country supervision					●							
25. Supervision of foreign establishments												

Source: IMF.

[1]) See Legend, Abbreviations and Definitions for a list of country codes.