Micro-Prudential Supervision: A Key FinSAC Business Line

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Introduction

Prudential supervision aims to safeguard individual banks from idiosyncratic risks and prevent them from taking too much risk. FinSAC provides independent, confidential, and tailored technical assistance to central banks and supervisory authorities in client countries to help improve and enhance the overall efficiency and effectiveness of the supervisory process. Our expert knowledge and experience enables us to help clients develop solutions that fit the specific needs and circumstances in their country and can deliver change.

Supervisory frameworks

FinSAC can help central banks and supervisory authorities in the Europe and Central Asia region to strengthen and upgrade micro prudential bank supervision frameworks.

These frameworks ensure that regulation and legislation are properly implemented, monitored and enforced. They encompass all activities, supporting procedures, processes, organization, systems and guidelines. Remedial or enforcement actions are also part of the supervisory framework, to be implemented when the safety and soundness of the supervised institution comes under threat. It is important that enforcement measures are timely, firm, proportionate, fair and even handed.

Too often supervisory frameworks are “compliance based”, focused only on ensuring compliance with regulation. This risks excessive focus on the formal aspects of non-compliance with little understanding of the risk profile of individual banks and potential threats to the banking system as a whole.

The transition towards more forward looking and risk based approaches should be implemented carefully but steadily. Nevertheless, an element of compliance monitoring remains necessary in every supervisory approach.
Supervisory frameworks evolve over time. Prudential supervisors can ensure theirs remains fit for purpose - adequately reflecting current environments and changing financial systems - by committing to regular reviews.

FinSAC assesses supervisory frameworks, or parts of them, against peer countries and international good practices. We understand that central banks and supervisory agencies face budget and staff-constraints - too often their good work is taken for granted and they only become “visible” when problems or shortcomings are detected. We therefore seek to help them achieve safety and soundness objectives and improve efficiency and cost-effectiveness, while enhancing the value-for-money of their important prudential work.

FinSAC offers a modular menu of options for the review of supervisory frameworks. In countries where AML/CFT supervision is closely aligned with the supervisory process, these aspects can also be assessed.

1. **Assessing the efficiency and efficacy of onsite supervision practices**

   *This module covers the policies and procedures for determining the scope and frequency of inspections, the planning of inspections, the preparation, content and quality of inspection reports, and the review of loan portfolios by sampling during on-site inspections.*

2. **Review the architecture and control framework within Bank supervision departments**

   *This module looks in detail at the governance and architecture of the supervision function. It can include, for example, enhancing onsite and offsite cooperation, the tradeoffs of having supervisory staff specialize in specific risk areas and exploring the implementation challenges, assessment of workload and resources, benefits and drawbacks of integration of onsite and offsite. It can also cover the assessment of the supervisory approval processes, the quality assurance and the governance of the supervision activity from planning to outcomes. The development of supervisory objectives and risk tolerance as well as performance measures of supervisory efficiency and effectiveness can also be reviewed.*

3. **Assistance with the assessment and/or development of supervisory methodology documentation and systems**

   *Prudential supervisors must be adequately supported and guided in the exercise of their duties. Supervisory materials should be precise, targeted and effective; but flexible enough to allow for professional judgment. Automated systems like data capture, data analysis, supervisory planning and resource management, can effectively be used to support the supervision framework.*

   *This module can include assessing and/or developing:*

   - [supervisory guidance, supervisory manuals and other tools for the preparation of supervisory risk assessments of individual banks or horizontal assessments of peer groups of banks;](#)
- supervisory plans; including the tailoring of supervisory procedures and expert teams to the individual institution;

- methodology for assessing a supervised bank’s business model and viability;

- the approach to design and implement supervisory strategies for individual banks based on risk profile, to keep the supervisory risk within the supervisory agency’s risk tolerance;

- methodology for remedial and recovery actions and their enforcement when supervisory actions need to be escalated;

- triggers for recovery and resolution actions.

4. **Modernization of supervisory practices to ensure compliance with specific Core Principles and EU’s EBA guidance**

FinSAC can assist supervisory authorities with the design and implementation of supervisory processes and procedures to ensure compliance with specific Basel Core Principles and EBA supervisory guidance, for example; related parties, corporate governance, consolidated supervision, risk management processes.

5. **Cross border banking supervision – home host issues**

Almost all of FinSAC’s client countries have banking systems that are dominated by foreign banks, mostly Eurozone banks. While global banks come with benefits for host countries, they also pose specific risks and challenges to host country supervisors.

FinSAC can work with client countries in the area of cross border banking supervision, including;

- risk assessments and supervisory strategies for specific risk posed by foreign banks; and

- addressing home host issues and building safeguards for contagion risk

- assisting host supervisors in handling cross border resolution issues

FinSAC teams work closely with their client counterparts throughout the process and their discretion is assured. FINSAC encourages openness and candor from supervisory staff at all levels in assessing problems and seeks to jointly arrive at remedial options. Full access to relevant documentation, confidential inspection reports, inspection planning, risk assessments and outcomes, is clearly essential for the FinSAC team but this can be made anonymous, as long as the nature of the individual bank is stated (for example state owned bank, systemically important bank, small bank).

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1 See the Basel Core Principles for Effective Banking Supervision
Regulatory frameworks

Banking laws and prudential regulations define a framework that induces banks to operate in a safe and prudent manner. This requires a consistent set of requirements including licensing; capital and liquidity requirements; corporate governance; asset valuation; supervisory reporting; prudent provisioning policies; public disclosure; risk management and fit and proper requirements.

FinSAC can assist client countries implement the numerous Basel and EU regulations, aligning them with country specific institutional development needs and constraints. FinSAC can help newer EU member states and EU candidate countries correctly implement EU requirements. We also advise countries seeking to join the EU on harmonizing national laws and regulations to meet EU requirements.

Tailored assistance can be offered in the following areas:

1. **Compliance and assistance with the implementation of the Basel and EU regulatory framework**

   This includes compliance with CRD IV/CRR and all its supporting regulations and requirements by performing or reviewing gap analyses of the existing capital and liquidity regulations comparing them to the CRD IV/CRR. It also covers assistance with the implementation of more principles based regulations such as Pillar 2. Basel III related assistance includes the development of country specific tailored criteria for identifying domestic systemically important banks, as required by CRD IV and Basel III, and assisting countries with the development and calibration of the various buffers included in CRDIV and Basel III.

2. **Compliance with individual Core Principles**

   FinSAC can assist supervisory authorities with the upgrade of regulations to ensure compliance with specific Basel Core Principles, for example: related parties; corporate governance; consolidated supervision; risk management process; and preparation for formal assessments or addressing the results of formal BCP assessments.

3. **Comparability of Non-Performing Loan (NPL) definitions**

   Consistency in the reporting standards for NPLs and provisions across countries has been a long standing concern. The scope of definitions of restructuring or forbearance and their respective classification differ in many countries. The European Banking Authority (EBA) has recently developed technical standards on supervisory reporting on forbearance and non-performing exposures to perform harmonized overall data collection on asset quality and lower costs for international banks by gradually decreasing divergent definitions. FinSAC can provide assistance with benchmarking the existing NPL identification and classification practices against international good practice, while taking into account specific country circumstances and products.

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2 See the Basel Core Principles for Effective Banking Supervision issued by the Basel Committee on Effective Banking Supervision in September 2012
4. Prudential impact of IFRS transition

When transitioning to IFRS, FinSAC offers help with assessing and addressing the prudential interactions of this IFRS implementation for banks. This includes not only policy advice on timing and safeguards when moving from deterministic regulatory provisioning models to expected loss methodologies, and from backward looking to forward looking provisioning, but also an assessment of the preconditions for increased reliance on IFRS\(^3\), particularly the IFRS 9 standard. In this respect, adequate collaboration and communication with external auditors is a key requirement.

**Approach, Results and implementation**

The management of the change process is as important as the diagnostic analysis, FinSAC’s advice and recommendations are only of value if they are adequately implemented by the relevant country authorities.

Change is achieved through a four phase approach (see chart below). Phase 1 involves a thorough diagnostic and technical analysis, leading to specific recommendations and options to consider to enhance supervisory processes. In Phase 2 senior managers agree and develop specific changes for implementation. Phase 3 covers the change process, with a carefully designed and implemented transition to a new supervisory structure or the adoption of new, more effective, practices. Finally, Phase 4 evaluates and validates the process, reviewing the adoption of the recommendations, either in their original form or with the adaptation of further changes along the way in a dynamic learning process. The FinSAC team is available to advise the authorities during implementation, and can conduct the final evaluation.

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\(^3\) FinSAC has cooperated with the Centre for Financial Reporting Reform
responsible for the adoption of the reforms and for fostering change. It is for them to agree the recommendations (in their original form or with amendments) and take charge of the decision-making process, moving from the top down, to implement successful change. The engagement of the most senior staff in the organization helps to overcome natural resistance from vested interests reluctant to implementing the agreed changes.

Capacity constraints mean that this product is available to only a selected number of client countries per year and that FinsSAC is unable to undertake all modules simultaneously in any one country. A targeted, modular approach will be followed addressing issues in order of priority to achieve maximum impact.