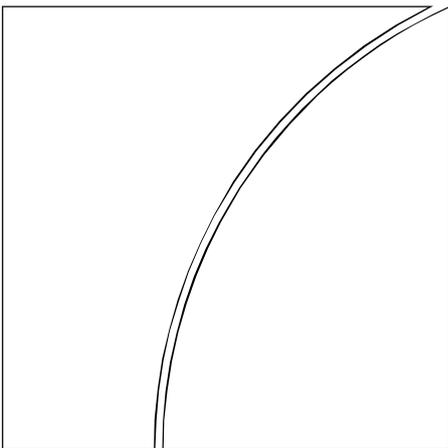


International Association of Insurance Supervisors

The Joint Forum

CORE PRINCIPLES

CROSS-SECTORAL COMPARISON



November 2001

THE JOINT FORUM

BASEL COMMITTEE ON BANKING SUPERVISION
INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS
INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS
C/O BANK FOR INTERNATIONAL SETTLEMENTS
CH-4002 BASEL, SWITZERLAND

CORE PRINCIPLES

CROSS-SECTORAL COMPARISON

November 2001

Table of Contents

1.	Executive Summary	1
2.	Introduction	4
	(a) Mandate.....	4
	(b) Approach	4
3.	Background to the Core Principles	5
4.	Subsequent Evolution	6
5.	Basis of the Comparison	7
6.	Relevant Characteristics of the Three Sectors	8
	(a) Banking.....	9
	(b) Insurance	10
	(c) Securities	11
7.	Analysis of Common Principles and Differences based on the Matrix	13
	(a) Pre-conditions.....	13
	(b) The Supervisory System.....	13
	(1) Objectives of supervision	13
	(2) Attributes of supervisory systems.....	14
	Operational independence and adequate resources.....	14
	Enforcement powers and capabilities.....	14
	(3) Clarity and transparency of supervisory process.....	14
	(4) External participants in the supervisory process	15
	(c) The Supervised Entity	15
	(1) Licensing, qualifications, ownership transfer and corporate control.....	15
	(2) Corporate governance	15
	(d) Ongoing Supervision.....	16
	(1) Group-wide supervision	16
	(2) Monitoring and on-site inspection.....	16
	(3) Reporting to supervisors	17
	(4) Cooperation and information sharing	17
	(5) Confidentiality	17
	(e) Prudential Standards	17
	(1) Risk management.....	17
	(2) Internal controls	19
	(3) Risk concentration	19
	(4) Capital requirements.....	19
	(5) Accounting policies and practices	20

(f)	Markets and Customers	20
(1)	Markets	20
	Market integrity	20
	Financial crime.....	20
(2)	Customer protection.....	21
(3)	Information, disclosure and transparency.....	21
(4)	Issuers	21
8.	Observations and Conclusions.....	22
9.	Options for Further Work.....	25
A.	Content of existing core principles.....	25
B.	Cross-sector interface	26
C.	Presentation.....	26
10.	Future Evolution.....	26
	Appendix A: Membership of the Working Group	
	Appendix B: Comparison Chart	

Comparison of Core Principles

1. Executive Summary

1. In March 2000, the Joint Forum set up a Working Group to compare the core principles issued by the Basel Committee on Banking Supervision (Basel Committee), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissions (IOSCO), identifying common principles and understanding differences where they arise. This report is based on the findings of the Group. The report was completed in Tendo, Japan, in July 2001 and has been updated after consultation with the parent Committees in August 2001.

2. Section 2 explains the origin of this task and describes the approach taken. The Joint Forum hopes that this analysis will help those assessing jurisdictions against the core principles gain a familiarity with, and understanding for, the core principles of all sectors and thus become more effective in their work.

3. Section 3 outlines the background to the core principles. While each sector worked independently in drafting its core principles, there was a great deal of similarity in the approaches taken; in all cases, the process involved extensive and broad consultations within the sector. The subsequent evolution of the core principles – such as the development of methodologies and self-assessment programmes – is discussed in section 4.

4. In both structure and content the core principles reflect characteristics of the respective sector and the nature of the supervised financial institutions, intermediaries and markets. Some of the sector specific attributes thus made a direct comparison across core principles a difficult task. The Joint Forum therefore adopted an issues-based approach described in Section 5. The resulting matrix mapping the core principles is contained in Appendix B.

5. Some of the similarities and differences among the core principles reflect intrinsic characteristics of the banking, insurance and securities sectors. Section 6 highlights sector specific factors necessary in understanding the core principles. Briefly,

- **Banking.** Linkages between the banking sector with the macro economy are perceived to be particularly strong, giving rise to potential concerns about systemic risk and financial stability. The Basel core principles encourage authorities to put in place supervisory frameworks that address significant risks – in particular, credit, concentration, market, liquidity, and operational risks. Unique among the three sectors, banking has an international capital standard. This standard was created to safeguard financial stability and counteract a deterioration of bank capital levels. Moreover, the standard was intended to reduce competitive inequalities across countries. Banks are supervised on a consolidated basis, reflecting the way the institutions themselves manage risk and, in particular, recognising the possibility of contagion risk within a banking group. Market discipline, enabled by good disclosure, is seen as an important adjunct to supervision.
- **Insurance.** Insurance offers protection against uncertain future events. Although this task is of considerable importance to the economy, usually the insurance sector is not a source of financial instability. In addition, despite the fact that most large insurance companies operate in many jurisdictions, supervisors have traditionally been able to “ring-fence” operations, thus containing problems. Much supervisory effort is directed towards the valuation of technical provisions, as they are estimations of the cost of future liabilities. Misestimation can affect pricing decisions

and the overall solvency of a company. Further, meaningful disclosure of information is more difficult to achieve in the insurance sector because of the many underlying assumptions supporting the valuation of liabilities. Because insurance products are often complex, generally insurance companies and intermediaries (i.e., insurance brokers) are subject to market conduct, in addition to prudential, regulation.

- **Securities.** Securities supervisors have very broad responsibilities. They encompass securities firms, markets, exchanges, collective investment schemes, and disclosure by issuers. There are many unique aspects to securities supervision reflecting, in part, this broader scope. For example, in some jurisdictions, self-regulatory organisations can be a valuable complement to the supervisor in achieving the objectives of securities supervision. In addition, securities supervisors place great importance on ensuring that investors are provided with the information necessary to make informed investment decisions on an ongoing basis. Consequently, full, timely and accurate disclosure of current and reliable information material to investment decisions is critical. There is also an emphasis on disclosure by intermediaries to clients of matters including investment risk and conflicts of interest. The broad scope of supervisors' enforcement powers is another aspect unique to securities supervision. This is because the complex character of securities transactions and the sophistication of fraudulent schemes require strong and rigorous enforcement of securities laws. This feature reinforces the need for close cooperation between securities supervisors at the domestic and international levels.

6. Section 7 contains the analysis of the core principles based on the matrix. In its analysis, the Joint Forum has sought to be comprehensive and balanced, drawing on intrinsic characteristics where necessary to explain differences. It emphatically avoided making any judgements as to whether the core principles are right or wrong, recognising that each is designed to meet sector specific needs.

7. Some of the highlights of Section 7 are:

- **Pre-conditions.** All sectors see sound and sustainable macro-economic policies and well-developed public infrastructure (legal, accounting, etc.) as preconditions to effective supervision.
- **The supervisory system.** All three sectors consider customer protection and systemic stability as objectives of the supervisory system. However, Basel places greatest emphasis on systemic stability and the IAIS on customer (in this case, policyholder) protection. IOSCO emphasises equally its three objectives of investor protection, fair, transparent and efficient markets and reduction of systemic risk. All sectors recognise the need for operational independence and adequate resources for supervisors, while acknowledging the importance of consulting with their respective industry groups and using outside participants for assisting the supervisory process. All sectors have the ability to apply supervisory sanctions but the IOSCO core principles are more detailed in describing the role of enforcement as a tool in the supervisory process.
- **The supervised entity.** All sectors require supervisors to have a regime for licensing entities and vetting of key individuals. Since there are different types of supervised entities in the securities sector, there are different types of licensing requirements. In the banking sector, there are restrictions on the use of the term "bank". All sectors encourage sound corporate governance within licensed entities.
- **Ongoing supervision.** All sectors require an effective framework for monitoring, on-site inspection and cooperation with other supervisors. Basel however regards consolidated supervision as mandatory, but the other sectors have the ability to require consolidated reporting or use other techniques to obtain a group-wide view.

Only the securities sector has enforcement powers that are comprehensive enough enabling supervisors to investigate and prosecute, extending beyond supervised entities. It also views cooperation with other supervisors as vital to fulfilling this role. IOSCO's core principles, unlike those of Basel and IAIS, do not distinguish the responsibilities of home versus host in guiding the flow of information between supervisors.

- **Prudential standards.** The sectors have taken different approaches to identifying the risks faced by the entities that they supervise. However, all describe the tools supervisors should possess to effectively manage risks. These include:
 - Setting capital requirements;
 - Ensuring that good accounting and valuation practices are followed;
 - Establishing limits on particular assets or exposures; and
 - Requiring that the necessary policies, procedures and reporting systems be put in place.
- **Markets and customers.** All core principles take some supervisory responsibility for the prevention of financial crime. IOSCO places additional responsibility on supervisors to detect and deter market abuses and fraud. IOSCO and IAIS make clear that supervisors have a role in protecting investors and customers; in particular, investors, intermediaries and policyholders should receive relevant material information to make buying and selling decisions.

8. Section 8 summarises conclusions and observations, notably

- Each set of core principles provides an overview of the key elements of the supervisory regime in that sector as at the time they were written. However the pace of developments in the financial sector since then would require consideration of the need for keeping the core principles updated. The impact of this varies between the sectors according to the structure of the relevant documents.
- There is no evidence of underlying conflict or contradiction between the three sets of core principles at the highest levels.
- There are numerous areas of common ground (e.g., authorisation, organisation of supervision, intervention). However it was established that in some cases, there are significant differences in the application of similar principles (e.g., different capital treatment of similar risks in different sectors).
- There are numerous differences between the core principles – some arising from intrinsic differences between the three sectors; others not readily explained in this way. Differences are found in the pre-conditions, group-wide supervision, cooperation and information sharing, safeguarding of client assets and application of uniform prudential standards.

9. In addition, the Joint Forum noted a number of significant developments since the core principles were originally drafted, all of which are considered to be in some degree relevant to a comparison of the core principles as they presently stand. These developments include:

- the use of the core principles as benchmarks for financial sector assessments, in some cases, going beyond the purpose for which they were originally designed;
- the increased provision of similar products and services in different sectors;
- the continuing emergence in a number of jurisdictions of financial conglomerates; and

- the establishment of integrated financial supervisors in a growing number of jurisdictions.

10. The report concludes by presenting some options for further work. These range from issues on the content of the core principles to cross-sector interface and presentation of the principles. Decision to pursue further work should be made by the parent organisations (Basel Committee, IAIS and IOSCO), which can best judge the needs of their members.

2. Introduction

(a) Mandate

11. Recently and independently, the Basel Committee, IAIS and IOSCO identified principles for effective supervision in their respective sectors. Implementation of these principles is being monitored, in some cases, through self-assessments and peer reviews, and by independent bodies such as the International Monetary Fund (IMF) and the World Bank.

12. The mandate of the Joint Forum to compare the core principles originated from a request made by the IMF and the World Bank. In assessing jurisdictions' compliance with the core principles, assessors and supervisory agencies being assessed had indicated the need for a better understanding of why the core principles differed in structure and format between sectors. A comparative analysis of the core principles from all three sectors was deemed beneficial in the implementation and assessment of the principles. Accordingly, at the April 1999 Financial Stability Forum meeting, the IMF and the World Bank suggested "that the Forum encourage a review of the consistency of the core principles developed by the various international supervisory groupings with a view to facilitating their implementation". It was felt that such an exercise would help assessors improve their understanding of the principles and thereby make the implementation and assessment process more effective.

13. This request was passed to the Joint Forum through its parent organisations and incorporated in an updated mandate released in December 1999. The Joint Forum recognised that this was a unique opportunity to gain an in-depth understanding of the three sectors' core principles. The mandate to the Joint Forum is "to compare the core principles issued by the banking, insurance and securities sectors, identifying common principles and understanding differences where they arise." It is not within the mandate to determine changes to the core principles. However, taking this report into account, the parent organisations may wish to consider where revisions to their core principles are desirable or necessary.

(b) Approach

14. The Joint Forum established a working group, consisting of members from each sector and also from the IMF and the World Bank (Appendix A). The work was divided into two phases. The first phase dealt with analysing the structure of each set of core principles and establishing where differences arise, while the second phase focused on looking at the reasons why these differences arise. The documents that formed the basis for this review included:

- The Core Principles for Effective Banking Supervision (September 1997) and accompanying methodology (October 1999);

- The Insurance Core Principles (October 2000) and accompanying methodology (October 2000); and
- The Objectives and Principles of Securities Regulation (September 1998)

The work did not however include a detailed review of the methodologies for the bank and insurance core principles. The methodologies were referred to as needed to add clarification to the comparison of the core principles themselves. In addition, analysis of the various guidance issued by the three standard setters fell outside of the mandate, although in some instances reference is made to these documents in the respective core principles or related methodologies.

15. From the outset, an objective approach to the comparison of the core principles was taken, avoiding any implicit judgements of whether any particular core principle was right or wrong. It was recognised that it is important to have a clear understanding of the objectives of each of the core principles.

16. In this report, observations and findings are presented in the following order: banking, insurance, securities. This order is adopted for the sake of consistency and has no other significance. Also, the term “supervision” is generally understood to apply to oversight of the banking and insurance industries, while the similar term for the securities industry is “regulation”, which includes the supervisory function associated with bodies charged with the supervision of securities firms and markets. For ease of reference, the terms “supervisory” and “supervision” are understood to include “regulatory” and “regulation”.

3. Background to the Core Principles

17. The need to strengthen financial systems attracted international attention, culminating in a call for action by the G7 at the Lyon Summit in June 1996. In particular, leaders recognised that financial systems, especially banking, and macroeconomic development are closely linked. The following year the Basel Committee reacted to this call for action by issuing the Core Principles for Effective Banking Supervision, with the aim of providing guidance for jurisdictions wishing to strengthen their supervisory regimes.

18. Around the same time the newly formed IAIS adopted a standard-setting role. The Insurance Supervisory Principles were drafted to provide a framework for this purpose and were adopted in 1997. By 2000, it became clear that the principles were also being used for another purpose. Specifically, the IMF and the World Bank assess compliance with financial sector standards mostly in the context of the Financial Sector Assessment Program (FSAP). The IAIS also introduced a systematic program of self-assessment for its members. These developments led to the IAIS updating and extending the document and renaming it as Insurance Core Principles.

19. IOSCO adopted the Objectives and Principles of Securities Regulation in 1998, recognising that sound and effective regulation brings confidence to the securities markets and strength to the economy, domestically and globally. The document provides securities supervisors with a common set of guiding principles and objectives.

20. While the backgrounds to the creation of the three documents were different, the processes followed were similar in many respects. In all cases the principles are supported by other supervisory guidance. In fact, the Basel Committee and IOSCO’s core principles are based largely on previously issued guidance, and since 1997 the IAIS has elaborated on many of its core principles.

21. In addition, each sector consulted broadly and extensively while developing its core principles. Members in both the IAIS and IOSCO come from developed and developing countries representing all regions of the globe. Membership in the Basel Committee is limited to the G10 (plus Switzerland and Luxembourg). However, in developing the Core Principles for Effective Banking Supervision, the Basel Committee established a Liaison Group that included non-G10 countries. All sectors invited IMF and World Bank participation, recognising the important role these organisations play in encouraging adherence and implementation.

4. Subsequent Evolution

22. To help with IMF and World Bank assessment programmes, the Basel Committee in 1999 and subsequently the IAIS in 2000 developed methodologies that include criteria for evaluating compliance with the principles. The criteria are divided into “essential” and “additional”. Essential criteria indicate the minimum level that all jurisdictions should fulfil, while additional criteria are best international practices that jurisdictions should strive towards.

23. IOSCO’s Objectives and Principles of Securities Regulation are supplemented by narrative discussion intended to illustrate how the principles might be achieved. IOSCO has developed self-assessment methodologies aimed at implementation. As a first step it has developed a high-level self-assessment methodology for the implementation of the principles by having members complete a self-assessment. More detailed self-assessment methodologies on specific sections of the principles are currently being undertaken.

24. Self-assessments have also been used by the Basel Committee and IAIS. The Basel Committee encouraged countries to complete a self-assessment when the Core Principles for Effective Banking Supervision were originally promulgated. Members of the IAIS completed a simple self-assessment of the Insurance Supervisory Principles in 1998 and have now been asked to complete a more detailed self-assessment based on the Core Principles Methodology. Now all three sectors’ self-assessments are used as part of, or in preparation for, IMF and World Bank assessments under the FSAP.

25. These self-assessments are intended to provide encouragement and direction to jurisdictions to strengthen their supervisory systems. At the present time, none of the international supervisory bodies uses compliance with the core principles as a condition of membership or to sanction jurisdictions.

26. The Basel Committee and IAIS intend to update and revise their core principles periodically, primarily as a result of developments in the industry, findings from the self or independent assessments, or the issuance of new supervisory standards. Currently, both are targeting revised principles and methodology for the year 2002.

27. IOSCO also plans to update the Objectives and Principles of Securities Regulation, as necessary. This document was crafted with the view that markets change significantly over time and that the supervisor must have flexibility to respond to changes, consistent with the core principles. The IOSCO core principles note that there is often no single correct approach to a supervisory issue. Minor amendments are presently being made to reflect work undertaken by IOSCO since the Objectives and Principles were adopted.

5. Basis of the Comparison

28. The structure of each sectors' core principles reflects the types of entities or markets that are supervised. The table below provides an overview of the structure of the three sectors' core principles grouped according to the sub-headings used in each sectors' documents.

CP	Basel Committee	CP	IAIS	CP	IOSCO
1	Preconditions	1	Organisation of an insurance supervisor	1-5	Principles relating to the regulator
2-5	Licensing and structure	2-3	Licensing and Changes in Control	6-7	Principles for self-regulation
6-15	Prudential regulations and requirements	4	Corporate governance	8-10	Principles for the enforcement of securities regulation
16-20	Methods of ongoing banking supervision	5	Internal controls	11-13	Principles for cooperation in regulation
21	Information requirements	6-10	Prudential rules	14-16	Principles for issuers
22	Formal powers of supervisors	11	Market conduct	17-20	Principles for collective investment schemes
23-25	Cross-border banking	12-13	Monitoring and on-site inspection	21-24	Principles for market intermediaries
		14	Sanctions	25-30	Principles for the secondary market
		15	Cross-border business operations		
		16-17	Coordination, cooperation and confidentiality		

29. Bank supervisors focus on the solvency of supervised institutions. Similarly, insurance supervisors focus on companies on the principle that policyholders will be protected if insurance companies comply with regulations and manage risk in a sound and prudent manner. Therefore principles in both these sectors describe the framework needed to supervise entities.

30. In contrast, as explained in section 6 below, securities supervisors not only supervise securities firms (or market intermediaries) but also collective investment schemes (both the products and the intermediaries who offer them) and secondary markets, (including exchanges and clearing houses) and disclosure by issuers. The principles address both prudential supervision and conduct of business issues. As a result, the structure of the Objectives and Principles of Securities Regulation is very different from those of the banking and insurance core principles. One part of the IOSCO document describes the desirable attributes of a supervisor and the role of SROs. It also considers the enforcement and market oversight work of the supervisor and the need for close cooperation between supervisors. Other parts make particular reference to collective investment schemes, market

intermediaries, secondary trading, the clearance and settlement of transactions, and disclosure by issuers.

31. Since the differing structures did not naturally lend themselves to a comparison of the core principles, the Joint Forum decided to take an issues-based approach and produced the matrix found in Appendix B. There are instances where the mapping of the core principles resulted in some “blank spaces” in the matrix. That is, categories that were not addressed in at least one sector’s core principles. These “blank spaces” are a natural and inevitable part of the comparison and help in identifying some of the key intrinsic differences among sectors.

32. A successful comparison of the core principles depends crucially on the choice of issues considered in the detailed work. In designing this framework, it was attempted to use “neutral” terminology, which meant that while all essential elements of the individual core principles were captured, these were not necessarily found under familiar headings. It was also sought to ensure that the comparison is rigorous and comprehensive without being unnecessarily specific, and, as noted earlier, avoid any implicit value judgements. It was important to have a clear understanding of the objective of each principle, not just using literal interpretations.

33. Perhaps the most difficult issue to compare across the three sectors proved to be that of risk. The treatment of risk is a fundamental aspect of the core principles and the understanding what the core principles have to say about risk and why is crucial to the value of the exercise. The approach was to make a comparison of how the core principles reflect what each sector regards as the key risks (risk identification), and what the respective core principles expect of management and/or supervisors in addressing these risks (risk management). It should be noted that the key risks for each sector, and the risk management techniques applied to them, are discussed in detail in the report of the Joint Forum on capital and risk assessment.

34. The Joint Forum has undertaken a comparison of the core principles, not of the actual supervisory practices in the three sectors. Nevertheless this report makes reference in certain places – notably in Section 6 below – to the way in which supervision is conducted. It is important to emphasise that, where it does so, the report sets out generalities to which there will inevitably be local exceptions that it is not practicable to catalogue in a report of this nature.

6. Relevant Characteristics of the Three Sectors

35. Some of the similarities and differences among the core principles reflect, at least in part, intrinsic characteristics of the banking, insurance, and securities sectors. Consequently, an analysis was undertaken of the similarities and differences of these intrinsic characteristics, restricting it self primarily to those areas that are most relevant to understanding the differences in core principles. Not all differences between the sectors are apparent from a comparison of the core principles, nor are all differences between the sectors relevant to such a comparison. In this report the Joint Forum makes no claim to have undertaken a comprehensive comparison of the three sectors more generally. This section of the report summarises the results of the analysis as an aid to explaining the differences between the core principles set out in section 7 below.

36. In general, the banking, insurance, and securities sectors offer a variety of financial products and services that facilitate the efficient transfer of economic resources or risk. In many jurisdictions the lines between the sectors have grown increasingly blurred; banks

engaging in securities activities, securities firms selling and exchanges trading financial instruments designed to hedge risk, and insurance companies offering savings vehicles, for example. Thus the traditional demarcation between the three sectors is subject to a process of erosion, in which the growth of financial conglomerates is a contributory factor.

37. This does not mean that products have become identical or that all financial services activities are generally provided by one type of business. There exist areas where the sectors differ, such as in the form of financial intermediation and risk transfer. The analyses were focused on intrinsic differences among the three sectors, recognising that the work may mask some areas where the sectors overlap. In addition, the high level approach to analysing sector differences may not fully illustrate the complexities within each of the sectors.

(a) Banking

38. Problems arising in any of the three sectors can have an impact on overall financial stability and, of course, vice versa. Traditionally, distress in the banking sector and instability in the macroeconomic environment have been perceived as reciprocally linked. Interaction between financial services and the economy is clearly not unique to the banking sector. Nevertheless, concerns about the importance of banks to the overall economy, including their use as a tool in the implementation of monetary policy, are reflected in the historic tendency of many governments to support their banking sectors during times of crisis, as well as the widespread existence of depositor protection schemes. Because of the strong linkage between the banking sector and the macro economy, banking supervisors - many of which are (or were) also central bankers - have placed a great deal of emphasis on systemic stability and preconditions for effective supervision.

39. A number of defined risks of banking activities are identified in the Basel core principles. The most significant risk for banks has historically been credit risk - which can be amplified by concentration risk - on the asset side of the balance sheet. Risk arises on the liability side as well, in the form of liquidity risk posed by maturity mismatches between short-term deposits and long-term loans. Other banking risks include market risk (including volatility in the trading book), interest rate risk in the banking book, foreign exchange risk, funding risk, operational risk, country and transfer risk, legal risk, and reputation risk. Banks are expected to have policies in place to identify, control, and manage these risks, and specific requirements in this regard (e.g., credit granting and monitoring procedures to manage credit risk) are described for individual risk categories.

40. Proper asset valuation is an important issue in the banking sector, particularly as it relates to loan valuation and provisioning. Failure to take adequate provisions against troubled loans can mask the true financial condition of a bank. Supervisors and bank counterparties consequently have an interest in ensuring that a bank values its assets properly and that the financial statements present a fair and accurate picture of the bank's financial condition. Supervisors also promote disclosure of information by banks, believing that market discipline can serve as an adjunct to regulation and reinforce the need for banks to behave in a safe and sound manner.

41. Supervisors in all three sectors must take into account the balance of advantage in making public any supervisory action that has been taken to prevent or remedy problems in supervised firms. This leads banking supervisors in many jurisdictions to avoid or postpone public disclosure of banks' problems because of the importance of maintaining confidence in the banking system. Public confidence is essential to ensure stable funding. Loss of confidence in the banking sector can create financial instability by resulting in a run on banks by depositors, with a subsequent systemic drain on liquidity.

42. Unique among the three sectors, a uniform risk-based capital standard (the Basel Accord) applies to all internationally active banks. In practice a large number of countries also apply the standard to domestic banks. The Basel Accord was created to safeguard financial stability and counteract a deterioration of bank capital levels. Moreover, this international standard was intended to reduce competitive inequalities across countries. It was first adopted in 1988, with several amendments and revisions in the years following. In January 2001, the Basel Committee issued for a second round of public consultation a major proposed revision to the Accord. This revision is intended to greatly enhance the risk sensitivity of the international capital framework.

43. In the banking sector, international business is conducted to a large extent through foreign branches and subsidiaries. Recent years have seen an increasing number of cross-border mergers as well. There is significant interdependence between internationally active banks in different countries through the interbank market and the payment systems. To supervise internationally active banks most effectively, supervisors have relied on a pragmatic home/host division of supervisory responsibilities supported by information sharing. In particular, host country supervisors are expected to share relevant information with the appropriate home country supervisor.

44. Within banking groups - both international and domestic - there is a risk of contagion from one part of the group to another. Banking supervisors are concerned that problems may spread to deposit-taking institutions within a banking group. The Basel Committee therefore requires that all banks be supervised on a consolidated basis, which should minimise double gearing of bank capital, ensure that risks are managed on a group-wide basis, and mitigate the risk of contagion within a banking group.

(b) Insurance

45. Insurance provides a safety net when underlying adverse events occur. Insurance firms themselves are directly affected by economic events such as interest rate movements, which can impact asset valuation, and inflation, which can result in policyholders cashing out policies. Moreover, economic distress leading to deteriorating social or economic conditions, or obligations to pay damages as a result of judicial rulings, can result in new liabilities and potentially catastrophic losses.

46. Insurers intermediate risks directly. They manage these risks through diversification and the law of large numbers. For example, diversification of policy liabilities can be achieved through reinsurance. Aside from these direct business risks, the most significant risks to insurers are generated on the liability side of the balance sheet. These risks are referred to as technical risks and relate to the actuarial or statistical calculations used in estimating liabilities. If these calculations are incorrect (for example, if one or more of the assumptions on which they are based prove to be inaccurate), the consequences for the insurer can be significant. In particular, premiums charged could be inadequate to cover the risk and costs, insurers may pursue lines of business that are not profitable, and liabilities may be under- or over-stated, masking the true financial state of a company. On the asset side of the balance sheet, insurers incur credit, market and interest rate risk from their investments, as well as risks arising from asset-liability mismatches.

47. Accounting plays an important part in the insurance sector. Of particular importance to insurers is the valuation of liabilities, which affects pricing decisions and the ability of the insurer to operate as a going concern. In order to assess a company's long-term solvency, supervisors need to obtain extensive information about the actuarial and statistical assumptions used to establish prices and technical provisions. However, similar disclosure is not normally provided to the marketplace. As a result market discipline has played a lesser

role in insurance supervision, largely because of the opaqueness of liability valuations. Nonetheless, the need for insurers and intermediaries to provide accurate and appropriate advice and treat customers fairly is recognised in many jurisdictions where the responsibility of insurance supervisors includes the conduct of business.

48. Insurance supervisors are concerned that disclosure to the public of regulatory actions being taken could cause policyholders or others to take actions that could worsen the situation the supervisor was trying to remedy. Furthermore, the public awareness of difficulties of individual companies might affect public confidence in the insurance sector as a whole. However, in at least some jurisdictions, a distinction is made between supervisory actions related to prudential issues, which tend not to be made public, and those related to conduct of business issues, where disclosure is more common.

49. While much reinsurance business is international in nature, the cross-border size of the overall insurance market is relatively small. Like banks, insurance companies establish subsidiaries and branches in foreign jurisdictions. However, in the case of branch operations, companies are generally required to “vest” assets (i.e., hold sufficient assets in the jurisdiction to cover the related policy liabilities). Because of the limited amount of cross-border business and ability to “ring-fence” operations by jurisdiction, the need for world-wide consolidated supervision has been less apparent for insurance supervisors, although this is changing, and cross-border cooperation is increasing.

(c) Securities

50. Supervision in the securities sector addresses more than just securities intermediaries (broker-dealers and investment advisors). It also includes securities markets, exchanges, collective investment schemes, and disclosure by issuers. Consequently, whereas banking and insurance supervisors deal almost entirely with the supervision of firms, securities supervisors have a much broader scope of jurisdiction.

51. The securities sector is sensitive to macroeconomic factors in that there is typically a predictable correlation between macroeconomic indicators and market sentiment. Extreme macroeconomic conditions can lead to rapid changes in confidence, resulting in, for example, runs on assets by fund managers or rapid unwinding of futures positions with leverage on equity values. A catastrophic loss of confidence, for whatever reason, on the part of the markets can lead to massive and rapid withdrawal of short-term funds, producing a collapse in asset prices. Securities firms are also potentially vulnerable to problems in the banking sector to the extent that payment and settlement systems are compromised; large-scale market default could bring gridlock to the payment and settlement systems. Consequently, securities supervisors place an emphasis on pre-conditions for effective supervision, sound market processes, observance of detailed operating processes, and trading and settlement issues.

52. Securities supervisors generally disclose enforcement actions. This is because in the securities sector, supervisory transparency and accountability are linked to the maintenance of confidence in the markets, which is vital for the maintenance of orderly markets. In the view of securities supervisors such transparency strengthens perceptions of regulatory predictability, which in turn facilitates normal market functions and improves the credibility of the enforcement process. In addition, transparency contributes to supervisory accountability.

53. Securities markets have a strong international component. An increasing number of securities trading platforms and clearing and settlement systems operate on a multi-jurisdictional basis, and a number of large, international firms operate in the securities

markets. Technology-based trading of securities and ease of remote access to the market by investors and securities firms also facilitates cross-border operations, including the cross-border raising of capital by issuers. Given the international nature of the securities markets, supervisory cross-border cooperation serves several purposes. As with supervision in the banking and insurance sectors, it allows for effective supervision of an institution where related companies trade in several jurisdictions. It also allows for the effective monitoring of risk across markets.

54. In addition to the characteristics discussed above, there are features unique to the securities sector that are reflected in the IOSCO Objectives and Principles of Securities Regulation. These need to be highlighted:

- **Self-Regulatory Organisations.** One of the unique features of securities supervision is that it may rely on market participants through self-regulatory organisations (SROs) to regulate some of their own activities under supervisory oversight. In some jurisdictions much of the inspection and supervision of entities engaged in the securities business is done by SROs, which also are primarily responsible for market surveillance and for rule enforcement with respect to their members. SROs must obtain supervisory approval for the rules by which they govern their members and activities, and a securities supervisor can directly enforce the rules if it finds that the SRO is unable or unwilling to take appropriate action. Supervisors can also bring an enforcement action against the SRO itself.
- **Issuers/Disclosure.** Investors are best able to make informed investment decisions when they have access to transparent financial reporting and full and fair disclosure regarding an issuer, its securities and the respective transactions. Securities trading depends on a continuous stream of current information. Adequate disclosure of financial information is essential to accurate price formation, informed investor choice, and efficient allocation of capital. Most jurisdictions take a disclosure approach whereby individual customers, rather than supervisors, have responsibility for evaluating the merits of an investment in the issuer's securities. While not all supervisors are responsible for issuers directly, there are detailed disclosure requirements as well as a general requirement that the materials used in connection with an offering not contain any material misstatements or omissions. A disclosure system relies on adequate accounting, auditing and financial reporting, in order to assist customers in determining the true position and profitability of enterprises and make informed decisions. High quality accounting and auditing standards are therefore a critical element of securities supervision.
- **Enforcement.** In many jurisdictions, securities supervisors have comprehensive enforcement powers. Securities supervisors generally have broader authority than their banking and insurance counterparts to investigate possible violations involving both supervised and non-supervised entities and individuals. Furthermore, many securities supervisors have the authority to compel production of information and to initiate legal proceedings themselves either administratively or in court for violations of securities laws. In addition, securities supervisors can recommend that the relevant domestic criminal prosecutors take enforcement actions. Securities supervisors require such comprehensive enforcement powers because individuals and entities other than supervised regulated firms can perpetrate securities violations. Investors are vulnerable to misconduct by intermediaries. Securities violations also can occur both on and off the securities markets.

Because of the internationalisation of the world's securities markets, the emphasis that securities supervisors place on investigation and enforcement and the fact that securities violations can be conducted from or involve activity or proceeds located in other jurisdictions, securities supervisors have developed an extensive network of

cooperative arrangements that facilitates their investigating and taking action on behalf of a foreign counterpart. In some jurisdictions, a securities supervisor may share information with and assist its foreign counterparts even where the supervisor has no interest in the enforcement matter itself. The IOSCO core principles address the importance of cooperation without regard to whether the conduct at issue would be a violation of the laws of the jurisdiction from which information is requested.

- **Market Surveillance.** Monitoring also involves market surveillance, which is unique to the securities sector. Securities supervisors and, where applicable, SROs are responsible for monitoring trading in listed securities to determine whether there is evidence of securities law violations.

7. Analysis of Common Principles and Differences based on the Matrix

(a) Pre-conditions

55. All sectors agree that effective supervision cannot take place in a vacuum and that it is dependent upon the existence of other factors, or “pre-conditions” outside the supervisory framework itself. Thus, all three sectors include in their respective core principles a list of pre-conditions necessary for effective supervision.

56. While all three sectors focus on pre-conditions, the core principles of each sector emphasise different areas. The Basel core principles state expressly that jurisdictions should have sound and sustainable macroeconomic policies and a well-developed public infrastructure. This reflects the role that banks traditionally have played in the financial system as discussed in Section 6(a). The IAIS core principles also mention preconditions; however, like the IOSCO core principles, these focus on the infrastructure needed for effective supervision (i.e., effective legal, accounting and, for IOSCO, tax frameworks) and not on macroeconomic policies.

(b) The Supervisory System

(1) Objectives of supervision

57. Each sector sets out key objectives for banking, insurance or securities supervision in its respective documents. In striving to meet these objectives, supervisors should be guided by the core principles.

58. All three sets of core principles mention both customer (i.e., depositor, policyholder, investor) protection and systemic stability as key objectives. In addition, IOSCO has a third objective: ensuring that markets are fair, efficient and transparent. This third objective reflects the role of supervisors in overseeing securities markets. As explained in section 6, banking and insurance supervisors oversee financial institutions, not markets.

59. Although all sectors regard systemic stability as an objective, the Basel core principles place greater emphasis on systemic stability and consider customer protection as a by-product of stability. The importance of banks to the macro economy and financial system generally is discussed in Section 6(a). According to the IAIS core principles, the key objective of insurance supervision is policyholder protection. IOSCO places equal weight on its three objectives: investor protection, fair, transparent and efficient markets and the reduction of systemic risk.

(2) *Attributes of supervisory systems*

Operational independence and adequate resources

60. All three sets of core principles mention the need for supervisors to have operational independence. Such independence is seen as the ability of supervisors to act without interference from the political process and supervised industries in day to day operational decision making. Independence does not mean that supervisors should not consult with the industry they supervise in the formulation of supervisory regulations. This consultation occurs in all three sectors, and its value is expressly recognised in the IOSCO core principles.

61. All three sets of core principles also contain detailed requirements for adequate minimum resources, legal protection for supervisory staff acting within their responsibilities, and staff observance of high professional standards (e.g., expertise and ethics).

62. Finally, the core principles in all three sectors mention the need for supervisors to be accountable to the public for their supervisory actions. This is achieved in part by issuing annual reports to the public.

Enforcement powers and capabilities

63. The core principles in all three sectors acknowledge that supervisors need powers to take remedial action on a timely basis to deal with impending and actual problems.

64. As noted in Section 6(c), the IOSCO core principles place the most emphasis on the significance of, and need for, comprehensive enforcement powers. This is a major difference among the three sets of core principles. While supervisors in all three sectors have the authority to investigate possible violations and take legal action against supervised institutions and associated individuals, securities supervisors also have wider authority to take action against non-supervised entities and individuals for violations of securities laws.

65. Another difference is the transparency of the enforcement process, which was discussed for each sector in Section 6. While investigations conducted by securities supervisors are not public, enforcement proceedings are generally public proceedings. Securities supervisors generally publish the results of proceedings and sanctions imposed to warn customers of particular entities, individuals or schemes. In the banking sector supervisory remedial actions of a prudential nature are not always publicly announced for fear that in so doing problems could be compounded, thus reducing the chance of the action being effective. Similar considerations apply to prudential issues in the insurance sector, although insurance supervisors in some jurisdictions favour disclosure of remedial action in respect of conduct of business issues.

(3) *Clarity and transparency of supervisory process*

66. All three sets of core principles require supervisors to adopt clear supervisory processes. Practices must be transparent to the public and comprehensible. Such clarity allows supervised entities to be certain of the rules to which they must adhere when undertaking their business activities. It also facilitates supervisors' accountability to the public.

67. All three sectors require that supervisory rules be applied in a consistent manner to all supervised entities.

(4) External participants in the supervisory process

68. External participants are parties outside the supervisory authority. Supervisors in all sectors may use external participants to assist in supervisory functions.

69. Each set of core principles cites the use of external participants (e.g., external auditors) in the supervisory process. Some external participants are specific to the sector. For example, the IAIS core principles explicitly refer to actuaries. Similarly, the IOSCO core principles discuss the role of SROs in complementing the work of supervisors. The potential role of SROs to the securities sector is described in Section 6(c).

(c) The Supervised Entity

(1) Licensing, qualifications, ownership transfer and corporate control

70. In most cases, entities must be licensed and the appropriate supervisor must vet key individuals before they can conduct banking, insurance or securities business. All three sets of core principles require that supervisors have a regime for licensing entities and regulating the appointment of key individuals. Supervisors should determine how entities and individuals qualify to do business in their jurisdictions. For example, qualification requirements may stress the competence, skill and ethics of individuals. Also, supervisors should have authority to set minimum standards for licensing entities and reject applications that do not meet the standards set.

71. In the securities sector, there may exist a broader array of licensing requirements because there are different types of supervised entities. Supervised entities include intermediaries (both broker-dealers and investment advisors), collective investment schemes, trading systems and markets. The IOSCO core principles address the licensing requirements for each of these entities. For example, when licensing new trading systems, the IOSCO core principles mention “operator competence” as being relevant.

72. All sets of core principles require that permissible activities of licensed entities be clearly set forth and allow each supervisor to define the list of permissible activities. Moreover, legal and regulatory restrictions on the types of business exist in each sector.

73. The Basel core principles protect the word “bank.” This is done to prevent the public from being misled by an entity that inappropriately represents itself as a bank. Customers can thus be assured that institutions using the word “bank” are supervised institutions and allowed to provide banking services.

74. All sectors have rules enabling the supervisory authority to be notified of ownership transfers of supervised entities. However, banking and insurance core principles specifically state that supervisors may accept or reject significant ownership transfers of supervised entities. Banking supervisors are required to have criteria in place for determining which acquisitions require prenotification and approval. Basel deems that a major investment in a subsidiary or affiliate could pose risks to the parent bank and wants to ensure that there is no obstacle to receiving all relevant information on the acquisition (for supervisory purposes).

(2) Corporate governance

75. All three sectors encourage sound corporate governance within licensed entities. Supervisors, if so authorised by domestic financial sector legislation, may establish corporate governance requirements, such as defining the roles and responsibilities of management.

76. While similar corporate governance requirements apply to supervised entities in all three sectors, these requirements also apply to issuers in the securities sector. For issuers, good corporate governance means accountability to shareholders by boards of directors in selecting, monitoring, compensating and, when necessary, replacing, the managers who direct corporate operations on a daily basis. Good corporate governance for issuers also means transparency and certainty in the system of corporate accountability and responsibility, on which access to capital markets depends.

(d) Ongoing Supervision

(1) Group-wide supervision

77. All sets of core principles require group-wide supervision. Treatment of group-wide supervision differs, however, among the three sets of core principles.

78. As noted in Section 6(a), the Basel core principles emphasise the importance of consolidated supervision¹. As a result, banking supervisors have access to information on banking and non-banking activities undertaken by the bank and its affiliated entities. Consolidated supervision allows banking supervisors to assess whether these banking and non-banking activities pose risks to the bank and, in turn, to the overall financial stability of the banking system.

79. Consolidated supervision is not generally required in the insurance sector. However, according to the IAIS core principles, supervisors should have the ability to impose reporting requirements on a consolidated basis. Furthermore, insurance supervisors take a group-wide approach by requiring that capital requirements be structured so as to prevent multiple gearing. The need for taking this group-wide view is also recognised in the core principles dealing with cross-border establishments.

80. The IOSCO core principles do not prescribe consolidated supervision. Securities supervisors have diverse ways to obtain information about the activities of a broker-dealer and its affiliates. The IOSCO core principles expressly state that supervisors need to obtain information about unlicensed and off-balance sheet affiliates of supervised entities. The IOSCO core principles also state the importance of enhancing cooperation with authorities responsible for supervising other parts of the group and establishing measures to safeguard regulatory capital within the individual firms.

(2) Monitoring and on-site inspection

81. All sectors require an effective framework for monitoring and on-site inspection of supervised entities to assess compliance with relevant laws and supervisory requirements. As discussed in Section 6(c), monitoring in the securities sector also includes market surveillance.

¹ Supervision of the banking group on a consolidated basis goes beyond accounting consolidation. It implies that there is a group-wide approach to supervision whereby all risks run by a banking group are taken into account, wherever they are booked. It is important to note that both accounting consolidation and consolidated supervision are key aspects of the supervision of banking groups.

(3) Reporting to supervisors

82. Supervisors in all three sectors can require from supervised entities information necessary to verify compliance with laws and supervisory requirements. All sectors expect supervisors to have the power to require the provision of information and the right to inspect relevant records. The Basel and IAIS core principles provide examples of the types of information that would be required (e.g., statistical returns and other prudential requirements) and identify other requirements, such as the frequency of reporting.

(4) Cooperation and information sharing

83. All three sets of core principles require supervisors to have arrangements for information sharing and cooperation both domestically and with foreign supervisors. However, the objectives of such arrangements differ among the sectors.

84. For the reasons set out in Section 6(a), in the banking sector, supervisors establish information-sharing arrangements between home and host country supervisors. Banking supervisors must have power to share with home country supervisors information relating to the local operations of foreign banks, and vice versa. These arrangements are necessary for consolidated supervision.

85. The IAIS core principles identify the need for adequate and effective communication in order for insurance supervisors to share relevant information with each other. In particular, consultation between home and host supervisors is necessary in the creation of cross-border insurance establishments (branches and subsidiaries). Insurance supervisors may rely on home country supervision “if prudential rules in the two countries are broadly equivalent”.

86. The IOSCO core principles address the need for information sharing mechanisms for both supervisory and enforcement purposes. The IOSCO document provides greater detail as to the scope of cooperation and the content of information sharing arrangements than the other sets of core principles. This includes cooperation between securities regulators and criminal and judicial authorities in cases of suspected fraud or market abuse.

87. Information sharing for enforcement purposes is not required by banking or insurance supervisors because they refer matters to other authorities in the event that legal action is necessary. The importance of information sharing mechanisms to securities supervisors is explained in Section 6(c).

(5) Confidentiality

88. Maintaining the confidentiality of non-public information is important to all three sectors. In particular, all sectors require that supervisory staff protect confidential information. Additionally, the core principles in all sectors require supervisors to have the ability to safeguard the confidentiality of information received from other authorities and ensure the appropriate confidentiality of information provided to other authorities.

(e) Prudential Standards

(1) Risk management

89. Supervised entities in all sectors are exposed to risks, and all supervisors agree that the entity should have procedures for effectively managing risk. The supervisor’s role is to ensure that effective risk management systems are in place and to establish standards of good practice, where necessary.

90. The Basel core principles expressly identify and describe the significant risks faced by banks, including, for example, credit, market, liquidity, and operational risk. Since the primary role of banks is to make loans, these risks largely (but not exclusively) affect the asset side of the balance sheet. Whereas IOSCO and IAIS have mainly a general approach to risk management, the Basel Committee includes specific elements of risk management in its core principles. A more detailed discussion of risks in the banking sector is contained in Section 6(a). Many risks that securities firms face are similar to those of banks. The IOSCO core principles refer to the detailed guidance given to supervisors on risk management in complementary IOSCO standards and papers.

91. As described in Section 6(b), while these risks also apply to insurance companies, the most significant risks for insurers relate to liabilities. An insurer's liabilities are estimations of the future cost of claims. Pricing decisions are made based on these estimates; in addition, asset portfolios are structured to match liabilities in terms of duration, currency, interest rate, etc. Therefore, any inaccuracies or misestimations in valuing liabilities can significantly affect a company's liquidity or financial viability. The IAIS core principles address prudential supervision by balance sheet category, identifying the respective tools supervisors should possess to manage risk effectively. For example, the IAIS core principles require the authority to prescribe standards for establishing technical provisions and check their sufficiency with regard to liabilities.

92. Tools for effective risk management that are described in all three sectors' core principles and related documents include:

- setting capital requirements;
- ensuring that good accounting and valuation practices are followed;
- establishing limits on particular assets or exposures; and
- requiring that the necessary policies, procedures and reporting systems be put in place.

93. Sometimes a particular risk is identified in the core principles of only one sector. This is generally either because the risk is unique to a sector - for instance, reinsurance risk in the insurance sector - or because of the way the document is structured. Off-balance sheet exposures, for example, are addressed separately in the IAIS core principles largely because the document is structured by balance sheet category. The other sectors treat the risks of off-balance sheet exposures no differently than on-balance sheet exposures.

94. Another example is proprietary trading, which is addressed specifically in the IOSCO core principles. Securities firms trade for proprietary purposes as well as on behalf of clients. In order to prevent unauthorised trading of clients' assets, securities supervisors need to be assured that firms' proprietary assets are physically segregated from client assets. In addition, financial responsibility requirements address risks associated with trading on behalf of clients. Proprietary trading is closely linked to prudential requirements since the adequacy of a firm's net capital will be determined relative to the risk associated with its proprietary trading. Trading on behalf of clients is not seen as a traditional activity for banks and insurance companies in many jurisdictions and is therefore not addressed in their core principles.

95. In addition, only the IOSCO core principles deal with the risks relating to secondary markets, collective investment schemes and clearing and settlement systems.

(2) Internal controls

96. Supervisors in all three sectors stress the importance of internal controls within regulated entities, recognising that these need to be tailored to fit specific industry circumstances. The supervised entities are responsible for establishing and maintaining appropriate internal controls; supervisors are responsible for ensuring appropriate controls exist. All three sectors consider that internal controls, as broadly defined, cover both internal procedures and external requirements such as compliance with relevant supervisory requirements.

(3) Risk concentration

97. The core principles of all three sectors provide rules limiting risk concentration. However, the type of risk concentration covered by such rules differs between the various sectors. For the Basel Committee, risk concentration is focused on counter party risk, and to some extent sectoral and geographic risks, in terms of assets. In the IAIS core principles, the main focus for controlling risk concentration is in promoting a suitably diversified investment portfolio. For the securities supervisors, risk concentration refers mainly to the impact on the markets of large positions being taken.

98. The Basel and IAIS core principles state that supervisors should have the authority to establish standards to limit concentrations in assets. Insurance supervisors should require companies to diversify their assets by type, including, where applicable, establishing limits or placing restrictions on particular assets. Banking supervisors must establish large exposure limits. The Basel core principles methodology sets forth very specific limits, reflecting previously established guidance issued by the Basel Committee.

99. The IOSCO core principles require market authorities to monitor large exposures on a market and to share information with one another to permit appropriate assessment of risk. Market authorities must establish trigger levels appropriate to their markets and continuously monitor the size of positions.

100. Reinsurance is a means of diversifying concentrations on the liability side of an insurer's balance sheet. Consequently, only the IAIS core principles specifically address reinsurance.

(4) Capital requirements

101. The core principles of all three sectors specify that supervisors should set capital requirements for supervised entities. In the case of IOSCO, this applies primarily to market intermediaries (i.e., securities firms). These capital requirements should reflect the risks undertaken by the entities. The Basel and IOSCO core principles expressly state that the capital requirements should be risk-based. IAIS expects insurance supervisors to take into account the size and complexity of insurance companies, in addition to the risks undertaken, in setting capital requirements.

102. As discussed in Section 6(a), the Basel Committee has established an international capital standard (the Basel Accord) which is intended to apply to all internationally active banks. Supervisors are expected to establish capital requirements - including defining eligible capital components - that are at least as strict as the requirements of the Basel Accord. IOSCO and IAIS, by contrast, expect supervisors to promulgate capital requirements but do not have a single international capital framework for their respective sectors.

103. Insurance supervisors have yet to develop an international capital standard, in part because there are still great differences in insurance accounting and actuarial standards

among jurisdictions. Work is underway both within the IAIS to identify principles on which a capital standard can be built and within the professions to harmonise accounting and actuarial standards.

104. Jurisdictional differences also preclude a uniform international capital standard in the securities sector. In contrast to banking and insurance supervisors' emphasis on the supervised entity as a going concern, securities supervisors focus their attention primarily on the liquidity of the entity. Generally, securities firms must have liquid assets in excess of liabilities so that the firm could be wound down in an orderly manner.

(5) Accounting policies and practices

105. Supervisors in all three sectors stress in their core principles that high-quality accounting policies and practices serve both supervisory purposes and the public interest. For IOSCO, this applies not only to market intermediaries, but to disclosure by issuers as well, as discussed in Section 6(c). The Basel and IOSCO core principles also refer to the importance of internationally acceptable auditing standards. The IOSCO principles note that these standards should be of high quality.

106. The Basel and IAIS core principles allow for supervisors to set accounting and valuation standards, recognising that, in some cases, these may be relevant solely for supervisory reporting purposes. Insurance supervisors, in particular, have generally found that commercial general accounting practices are not appropriate for the insurance business in part because of the extent to which an insurer's liability can only be based on estimation. Only the IOSCO core principles describe the characteristics of acceptable accounting and auditing standards. High quality accounting and auditing standards are necessary safeguards of the reliability of financial information in the securities industry.

(f) Markets and Customers

(1) Markets

Market integrity

107. The importance of ensuring market integrity is cited solely in the IOSCO core principles. This is a function of the role of securities supervisors in overseeing securities markets, whereas banking and insurance supervisors generally oversee individual firms but not the markets themselves.

Financial crime

108. All three sectors' core principles discuss the role of supervisors in addressing fraud and money laundering.

109. The Basel core principles indicate that banking supervisors should have appropriate laws or supervisory requirements in place and should expect bank management to establish internal controls to prevent the bank from being used in fraudulent or criminal activities such as money laundering. The Basel core principles state that banks should be required to report suspicious activities and significant incidents of fraud to their supervisors. The IAIS takes a similar view.

110. The IOSCO core principles address money laundering in a like fashion. However, the IOSCO core principles do not impose a requirement for supervised entities to report suspected money laundering activity to the supervisor. The IOSCO as well as the Basel core principles do refer to the recommendations of the Financial Action Task Force on Money

Laundering (FATF) as additional guidance to the principles themselves. In addition, unlike the Basel and IAIS core principles, the IOSCO core principles require supervisors to have enforcement powers to detect and deter market abuses. This is described in Section 6(c).

(2) Customer protection

111. Both the IAIS and IOSCO core principles make clear that supervisors in their respective sectors have a role in protecting customers.

112. Customer protection is not specifically addressed in the Basel core principles, except to the extent that depositor protection is cited as an objective of banking supervision. This may be in part because not all jurisdictions were involved in customer protection when the Basel core principles were drafted. Although this has changed in many jurisdictions in recent years, customer protection is not mandated for bank supervisors in all countries.

113. As described in Section 6(b), the IAIS core principles focus on the importance of insurer and intermediary (i.e., broker) conduct vis-à-vis customers. This is a function of their central role in the sale of insurance products.

114. The IOSCO core principles state that investor protection is one of the three objectives of securities supervision and the core principles work together to achieve the stated objectives. The IOSCO core principles, for example, state that securities supervision should govern the segregation and protection of client assets that are held separate from company funds. This applies not only to firms, but also to specific products such as collective investment funds. The IOSCO core principles also address investor protection through principles on disclosure and enforcement powers.

(3) Information, disclosure and transparency

115. Each of the three sectors' core principles notes the importance of disclosure and transparency, although with different aims.

116. The Basel core principles do not address customer disclosure. However, they do address the importance of market disclosure. In particular, public disclosures are seen as playing an essential role in imposing market discipline on banks to operate in a safe and sound manner. This is discussed in Section 6(a).

117. The IAIS core principles emphasise the importance of requiring disclosure to customers so that they have the information necessary to make appropriate decisions relating to their insurance contracts.

118. The IOSCO core principles address disclosure by intermediaries to investors. In addition, the IOSCO core principles address disclosure by issuers and disclosure about trading on a market. For securities supervisors, public disclosure and transparency are essential to allowing investors to make timely, informed investment decisions, as described in Section 6(c). Furthermore, transparent trading promotes confidence that the pricing and functioning of the market is fair.

(4) Issuers

119. This item is only referred to in the IOSCO core principles and is unique to the securities sector. Discussion of disclosure by issuers is contained in Section 6(c).

8. Observations and Conclusions

120. A side-by-side comparison of the key documents highlights differences in format, style and language. It is also apparent that the three sectors' core principles have different origins. Analysing these differences, and understanding how they arise, is important in distinguishing between issues where the core principles differ in form and those where they differ in substance. This is the reason, as explained in Section 5, why it was decided to undertake a detailed comparison based not just on the text of the core principles but on the underlying issues as well.

121. The Joint Forum found that a thorough comparison of this kind is necessary but not in itself sufficient for identifying common principles and differences. The results of that comparison, as set out in Section 7, are the product of extensive discussion within the group. The comparison actually reveals a good deal more by way of similarity between the three sectors than initial appearances might suggest. On some important issues, the core principles have many common features, in respect of the supervisory system, the supervised entity, ongoing supervision and at least some aspects of prudential requirements (for example, all three sectors stress the importance of internal controls within regulated entities - see paragraph 96). Only in the area of markets and customers does it become difficult to establish such high-level common ground, and that is primarily because of the difference in the traditional scope of supervisory responsibility between the three sectors.

122. Inevitably, the work undertaken has had limitations, and has not necessarily exposed every possible area of conflict or contradiction between the requirements of the three sectors. In particular, while the analysis has drawn on the methodologies to assist the comparison of the core principles (see paragraph 125 below), a comparison of the methodologies themselves has not been undertaken. With that caveat, no evidence of underlying conflict or contradiction between the three sets of core principles has emerged from the comparison. In other words, there is no reason to suppose that adherence to the core principles of one of the three sectors automatically causes supervisors or supervised entities to be in breach of the core principles of either of the other two sectors.

123. There are nevertheless significant differences in both presentation and content which need to be considered in determining the extent to which they may impair the effectiveness of the core principles in practice, particularly in terms of cross-sectoral work on assessment or for integrated supervisors. Differences of form, style and language exist and cannot be ignored. The core principles documents are clearly not based on a common template, and do not have a common structure. They were written at different times, which means that circumstances may have changed and thinking evolved meanwhile. Discussions in the course of the Joint Forum's work were often indicative that the core principles were written by different people with different backgrounds and consequently reflect different perspectives and philosophies. They were written for different audiences - the three 'constituencies' are very different in terms of numbers and diversity of membership and jurisdiction. The IOSCO objectives and principles were written for the use of IOSCO members. Although the international financial institutions, especially the IMF and World Bank, had an interest in these objectives and principles, and were consulted along with IOSCO members on the content, the objectives and principles were not designed primarily for assessment purposes. By contrast, the Basel and IAIS principles were written both for self and external assessment. But it would be wrong to see these differences purely as accidents of independent evolution, when in some cases at least they result from deliberate choices on the part of the standard-setting bodies.

124. Differences in the use of language and terminology can present particular problems. They can create the risk of misunderstanding where the same word or phrase is used by different sectors with a different meaning or nuance: an example is the word 'intermediary'

which has different meanings for IOSCO and IAIS. Conversely, the use of different words or expressions by different sectors can cause confusion where the underlying meaning is the same - for example 'solvency margin' as used by IAIS has essentially the same meaning as 'capital adequacy' for Basel. Other terms to which this applies include 'corporate governance' (which is the subject of the detailed study by the Joint Forum on Corporate Governance and the use of the audit functions in the supervisory process) and 'large exposures'. The issue is widely acknowledged; addressing it is complicated by the fact that the use of language and terminology is not necessarily under the control of the supervisors but often reflects conventional usage in the sector concerned.

125. In each sector a full understanding of the core principles cannot be gained from reading the basic core principles document on its own. In the case of Basel and IAIS, as explained in paragraph 22 above, methodologies have been developed to facilitate understanding for assessment purposes of how the core principles should be applied in practice. These methodologies typically refer to further guidance issued by the IAIS and Basel Committee, to give assessors a better understanding of the intent of each core principle. For IOSCO, by contrast, the text of the core principles itself gives more detailed guidance, but for the purposes of implementation rather than assessment, and in this case the document makes extensive reference to other IOSCO papers, typically by way of footnotes.

126. Each sector's core principles provide an overview of the key elements of the supervisory regime in that sector as at the time they were written. However, the pace of developments in the financial sector means that the core principles documents may periodically need updating. The impact of this varies between the sectors according to the structure of the relevant documents. For example, both the IAIS and IOSCO core principles refer to exchanging information specifically with supervisors from the other sectors, while this reference is not found in the Basel core principles. Sharing information with other sectors has increased in importance as a result of the developments in cross-sector conglomerates.

127. Section 7 of this report shows that the underlying principles of the three sectors are very similar in a number of areas such as authorisation, the organisation of supervision, and the circumstances in which supervisors should intervene. In many cases it is in the application of the principles, rather than in the principles themselves, that the differences occur. As a simple illustration, notification of ownership transfers is a common requirement, but the action to be taken in response to that notification may not be the same. A more complex example is that the core principles of all three sectors require capital to be held against risk but each sector assesses and aggregates risks in a different manner. Only the Basel core principles specifically refer to how the minimum capital standards are applied by making reference to the Basel Capital Accord. (This area is being further explored in the study on Risk Assessment and Capital.)

128. Intrinsic differences between the sectors, discussed in Section 6, are of course one of the main sources of differences between the core principles. It is not surprising to find that differences between the core principles arise from differences in the characteristics of the sectors to which they apply. Some examples include IAIS's emphasis on the valuation of liabilities and IOSCO's focus on markets and issuers.

129. There are, however, some significant differences which emerge from the comparison of the core principles which are not readily explained either as differences of form or as intrinsic differences. These differences were discussed at length without reaching complete agreement on the reasons for the differences, which appear to be attributable to differences of choice of supervisory approach, objectives or underlying philosophy. They include:

- **Preconditions** (paragraphs 55-56). The existence of preconditions is a common feature of each sector's core principles, but the expectations set out in these preconditions is different, for example in respect of the emphasis on macro-economic policies and market infrastructure, for no obvious reason. This point is also noted in terms of the objectives of supervision (paragraph 59), where the Basel Committee places greater emphasis on systemic stability.
- **Group-wide supervision** (paragraphs 78-80). Again the basic requirement is common, but the main differences as to how that requirement is to be fulfilled appear to follow from differences in perception of risk between the sectors. (This is also an example of a similar principle confused by differences of terminology.)
- **Cooperation and information sharing.** For IOSCO, the scope of cooperation and information sharing is very wide. IOSCO places significant emphasis on enforcement powers (paragraph 64) and protection of investors in securities supervision. This is further reflected in terms of the importance it attaches to cooperation and information sharing (paragraph 86).
- **Safeguarding of client assets** (paragraph 114). This is partly intrinsic in that it is not a core business for insurers. Considering that banks also offer safekeeping of assets as one of their products, it is not clear what accounts for the differences in detail between Basel and IOSCO on this issue.
- **Application of uniform prudential standards** (paragraph 102). The Basel core principles alone incorporate the requirement for a uniform risk-based capital standard. This standard was created to safeguard financial stability and counteract a deterioration of bank capital levels. Moreover, the standard was intended to reduce competitive inequalities across countries. However, while not specifically mentioned in the core principles, it is acknowledged that the IAIS is moving towards an international capital standard (paragraph 103).

130. In considering the treatment of risk in the core principles, significant differences were found in the extent to which the core principles documents bring out what each sector regards as its key risks, although in no case should the core principles on their own be regarded as a sufficient guide to risk management in the sector concerned. Each set of core principles refers to the link between financial stability and systemic risk, but without expanding on what is meant by systemic risk. Compliance with the core principles is not to be regarded as guaranteeing financial stability.

131. In the course of the work, a number of significant developments were noted affecting the financial sector generally since the core principles were originally being discussed and drafted. These developments include:

- the use of the core principles by international financial institutions (IFIs), especially the IMF and The World Bank, for purposes of financial sector assessments, going, in some instances, beyond the purposes for which they were originally designed;
- the increased provision of similar products and services in different sectors;
- the continuing emergence in a number of jurisdictions of financial conglomerates; and
- the establishment of integrated financial supervisors in a growing number of jurisdictions.

132. These developments are considered to be relevant partly because of the different extent to which they may have influenced each sector up to now and partly because they should be borne in mind in considering the ongoing evolution of the core principles.

9. Options for Further Work

133. While the Joint Forum's mandate does not extend to making proposals for action in the light of its findings, it is nevertheless putting forward some options for further work. The Joint Forum recommends its parent organisations to study these options and consider whether to pursue further action.

134. The identified differences will potentially affect a number of different parties, and their significance will vary accordingly. The options set forth below should therefore be considered from the perspective of both the implementation of the core principles and the assessment process, and from the point of view of, for example:

- the supervisors in the sector concerned;
- supervisors in the other sectors (this is particularly relevant with regard to the supervision of financial conglomerates);
- governments setting up supervisory systems or contemplating changes in them;
- independent assessors (such as the IFIs);
- supervised entities; and
- others (public, academics, etc).

135. Arguably, differences at the implementation level may not greatly matter to individual sectors in isolation. But they may become more important in the context of cross-sectoral supervision and the emergence of integrated supervision, and may impede fair and effective supervision and assessment of the financial sector in general.

136. The options are grouped under three headings:

- A. Content of existing core principles
- B. Cross-sector interface
- C. Presentation

For each option brief comments are given summarising the perceived benefits and drawbacks involved.

A. Content of existing core principles

137. These options seek to address issues where the Joint Forum has identified the potential for misunderstanding, confusion, or inconsistency in the interpretation or application of the core principles.

138. *Clarify definitions of key terms used in the core principles.* This would help to improve understanding of the core principles and would reduce the possibility of confusion. Each sector might wish to consult its own membership about the terms to be clarified and the definitions to be used. Some useful input may be provided by the work of the Joint Forum undertaken on risk assessment and capital. However, many of the terms used are terms of art or highly technical and simple definitions will not always be possible.

139. *Review core principles relating to group-wide supervision* with regard to their scope, effectiveness and consistency. Work in this area could make an important contribution to reducing the risk of supervisory arbitrage, and could draw on the work already undertaken by

the Joint Forum on this subject. The task is likely to be complicated, however, by different sectoral objectives, structures and local practices.

B. Cross-sector interface

140. These options arise from the observation that no one sector can be viewed in complete isolation from the others, as evidenced by the existence of the Joint Forum. This implies a need for consultation between the sectors in developing and implementing their respective core principles.

141. *Add cross-reference to other sectors' core principles* where appropriate. Cross-referencing would benefit cross-sectoral supervision and help assessors in their evaluation, particularly in cases where two or more sets of core principles give rise to similar but not necessarily identical requirements (for example, reporting to supervisors). Care might be needed to avoid giving the unintended impression of one sector's core principles 'endorsing' those of another. However, the comparison chart (Appendix B) demonstrates that this would not be an easy task.

142. *Provide for consultation between sectors on issues of common interest when changes to core principles are envisaged.* Such consultation would promote cooperation between supervisors of different sectors and would reduce the risk of unnecessary differences or inconsistencies between the core principles. An additional layer of consultation could, however, extend the process of amending the core principles.

C. Presentation

143. The option under this heading is concerned with the ease of use of the core principles documents; how readily they can be consulted, how easy it is to find a particular topic in each case and how different sectors' requirements can be compared. The focus is therefore on the core principles as tools of reference. This option involves little or no change to the core principles themselves.

144. *Develop a matrix-type guide to the core principles*, on the lines already produced (appendix to this report). Such a guide would permit easier navigation through the existing core principles documents and better understanding of their contents, and would facilitate cross sector comparisons. For these purposes it could be particularly useful for integrated supervisors, assessors and other interested parties. While much of the work on this option is accomplished, the matrix would require updating as the core principles evolve.

10. Future Evolution

145. In addition to the options set out above, the three parent Committees need to consider whether the core principles should be revised to take into account contemporary developments such as e-commerce, transparency, corporate governance, and financial conglomerates. The case for doing so is to enhance the topicality and credibility of the core principles, and to maintain their usefulness for supervisors, assessors and others. The difficulty, apart from the need to amend the core principles, is the risk that supervisors might be seen to be "moving the goalposts" for those economies which are in the process of implementing the existing set of principles. That could undermine efforts to achieve higher standards of supervision.