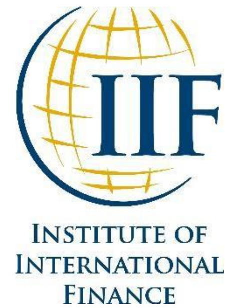


October 6, 2023

Mr. Neil Esho
Secretary General
Basel Committee on Banking Supervision
Centralbahnplatz 2
4051 Basel, Switzerland

RE: Consultation on the Core Principles for Effective Banking Supervision

Dear Mr. Esho:

The Institute of International Finance ("IIF") and the International Swaps and Derivatives Association ("ISDA") (and, collectively, "the Associations") are grateful for the opportunity to provide feedback to the Basel Committee on Banking Supervision ("BCBS" or the "Committee") concerning its consultation on updates to the Core Principles for Effective Banking Supervision (the "Core Principles" or, the "Consultation").[1] The Associations believe that the Core Principles are essential in order to continue to achieve an effective foundation for the supervisory and regulatory architecture in BCBS member jurisdictions.

We consider this update timely and important in ensuring that a consistent approach to supervision is achieved on a cross-border basis, taking into account the substantial adjustments to the global financial regulatory system over the past decade. We also agree with the Committee that recent geopolitical, financial, and economic events have reinforced the need for systemic resilience to a range of different shocks and have highlighted the particular importance of supervisory efficacy. Indeed, the learnings from the stress events of this year in particular should be considered in a timeframe shorter than the usual review cycle of the Core Principles, via consultation with the industry.

Though many of the changes to the Core Principles are embedded in the Basel standards and form part of the post-2012 systemic architecture more generally, our comments highlight specific areas where clarification, adjustment, or alignment warrant further consideration by the Committee as revisions are finalized. A key issue is to ensure that the Core Principles do not intrinsically introduce any new standards, either intentionally or unintentionally, which have not been previously introduced, and consulted on, through other relevant BCBS processes and documents. A balance must also be struck between essential and additional criteria, the revisions must be proportional across the financial services industry whilst addressing material risk, and the practical implications of implementation must be considered to avoid any potential unintended consequences.

As such, this letter provides feedback on specific areas of the Consultation in relation to *1. financial risks; 2. operational resilience; 3. systemic risk and macroprudential aspects of supervision; 4. new risks, including climate-related financial risks and the digitalization of finance; 5. non-bank financial intermediation; 6. risk management practices; and 7. other issues which arise in the wider context of the revisions.* We note that in certain areas of our feedback, remarks appear relating to different risk types which may intersect, and we reference where issues may overlap with additional areas of strengthening.

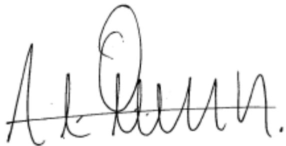
[1] BCBS, *Consultative Document, Core principles for effective banking supervision*, July 2023

The sweeping changes undertaken since the global financial crisis have led to a more stable system, however, overlapping, and competing requirements still give rise to issues impacting cross-border financial intermediation. We believe this exercise of updating the Core Principles provides an opportunity for the Committee to further enhance the necessary coordination and cooperation among supervisors from different jurisdictions and address the negative consequences of fragmented approaches to the supervision of cross-border firms.

Ultimately, there needs to be a continued focus on achieving efficiency as well as efficacy in regulation and supervision. Ensuring an appropriate balance between resilience, systemic stability and market efficiency needs to be addressed throughout the design and implementation of supervisory principles as well as the underpinning regulatory framework.

Thank you very much for considering our comments and we hope they prove useful as the Committee continues its important work in this area. If you have any questions, please contact us or Matthew Ekberg of the IIF at mekberg@iif.com and Lisa Galletta of ISDA at lgalletta@isda.org .

Very truly yours,



Andrés Portilla

Managing Director and Head, Regulatory Affairs

IIF

Panayiotis Dionysopoulos

Head of Capital

ISDA

Key Issues: Consultation on the Core Principles for Effective Banking Supervision

1. Financial Risks:

The focus by the international regulatory community on financial risks has been well developed over the last decade, with clear elements of the system strengthened in the wake of the global financial crisis. As such, the Associations agree that it is important to align the supervisory areas under Core Principle ("CP") 16 (capital adequacy), CP17 (credit risk), CP18 (problem exposures, provisions, and reserves), CP19 (concentration risk and large exposure limits), and CP23 (interest rate risk in the banking book) with relevant regulatory changes.

However, it is also very important that the Core Principles are updated strictly in line with developments considered through the processes developed by the BCBS and implemented on a jurisdictional basis. Intrinsically introducing any new standards via the revisions to the Core Principles which have not been introduced, and consulted on, through other relevant BCBS processes and documents should be avoided. The same issue arises in other areas of the Consultation which are outlined herein, but the following point for financial risk may be considered novel and warrant further consideration:

- The revision to CP16(7) adds the provision that "*The supervisor has the power to impose a simple, transparent, non-risk-based measure that captures all on and off-balance sheet exposures to supplement risk-based capital requirements to constrain the build-up of leverage in banks and in the banking sector.*" We note that supervisors already have powers to impose non risk-based measures to control leverage and thus it is unclear which BCBS standards or guidance would establish such revision to the Core Principles more generally. The Core Principles should ultimately be clear that they are established with a basis in agreed regulatory standards, as noted above. In particular, when prudential requirements such as a minimum leverage ratio are implemented in line with the Basel III Leverage Ratio framework, supervisors should be expected not to add-on additional requirements to the agreed prudential requirements.

Other issues concern the practical implementation of the Core Principles. Specifically, we note the following regarding financial risks:

- Under CP18(4), the revision states that "*The supervisor determines that banks' credit loss provisions and write-off methodologies and levels are subject to an effective review and validation process conducted by a function independent of the relevant risk-taking function.*" We note that in general this is valid and holds true for provisions calculated by a model (*i.e.,* for the performing and the defaulted homogeneous portfolios) and loan-loss provisions are often calculated and/or 'validated' by a function that is not the risk-taking function to ensure an appropriate level of provisioning.

  However, individual provisioning for defaulted non-homogeneous assets is not model based. Consequently, there is no validation by an independent function and the meaningful application of back testing is very limited as provisions are recalculated based on recent information on a quarterly basis. Specific risk provisions determined at client level based on expert assessment of the specific (idiosyncratic) circumstances are not part of this validation process. As such, we recommend that the Committee reevaluate the revisions herein to reflect the practices available and applied regarding validation.

We note that a reference to sectoral capital requirements has been added to CP16 (Additional Criteria, Section 3). It is essential that sectoral capital requirements are only used after an evidence-based cost-benefit analysis if it is demonstrated that banks are exposed to a material risk which is not already reflected elsewhere in the Pillar 1 or Pillar 2 risk management and capital frameworks. This is necessary to avoid introducing unintended consequences with that tool.[2]

Lastly, we note the greater supervisory focus that emerges in general in relation to CP18 concerning problem exposures, provisions and reserves which are largely related to expectations conveyed in the International Financial Reporting Standard ("IFRS") 9 Framework. We believe, however, that two new aspects which focus on resources[3] and the need for an additional control layer for an independent function[4] should be considered carefully and proportionally as the Core Principles are instituted, taking into account the potential additional pressures on the requirements that already exist in this area.

2. Operational Resilience:

The Associations welcome the incorporation of the BCBS *Principles for Operational Resilience* ("POR") and *Revisions to the Principles of Sound Management of Operational Risk* ("PSMOR") into the revised Core Principles. Operational resilience is extremely important for the public and private sectors to maintain confidence in the financial industry and to support financial stability and economic growth. Operational resilience is important for individual institutions, and across the financial sector, in support of customers, markets and the communities and broader economies they support nationally and globally.

Operational risk and operational resilience operate on a continuum; as defined by the BCBS, operational resilience is an outcome that benefits from the effective management of operational risk.[5] It is important that supervisors appropriately account for this relationship in order to avoid a bifurcation of risk and to permit firms to balance their prevention and recovery efforts. Treating them separately increases risks associated with fragmentation. We encourage the BCBS to acknowledge the continuum and complementarity between operational risk management and operational resilience in the final Core Principles, perhaps as part of the introductory material that explains why the two topics are covered in the same principle (CP25). This overarching framing may help supervisors as they implement the Core Principles by allowing them to take a more outcomes-based and non-fragmented approach to supervision of these topics. This could be particularly helpful recognizing some of the jurisdiction-specific initiatives underway.

The Core Principles could make clear that even where certain expectations under the PSMOR are not in the POR, there are still important, albeit indirect, considerations for the POR and that these would not be an extension of the POR, but reinforcement of the connectivity between the two. We would note, however, that in some parts of the Essential Criteria it may be difficult to grasp the alignment between the two; it would be helpful for the Essential Criteria to include drafting to reinforce their connectivity as appropriate. Essential Criteria Section 9 is a good example of where the expectation is clearly all encompassing of both operational risk and resiliency. Notwithstanding this, it is important that the Core Principles continue to maintain clarity over the definitions of key terms such as "critical operations", which have specific meaning in the context of operational disruptions.

[2] This issue is also emphasized in Section 4a of this letter.
[3] CP18(4) and (5)
[4] CP18(4)
[5] Footnote 66

As noted previously, for transparency and clarity of expectations, it is important that the revisions to the Core Principles do not introduce new expectations which have not been previously introduced, and consulted on, through other relevant BCBS processes and documents. We have identified some new elements in the revisions to the Core Principles that are novel and additive to the PSMOR and POR. For example:

- CP25 Essential Criteria Section (9)(h): *"The supervisor determines that banks' third-party risk management policies cover: … banks' right to audit and ability to request reporting (e.g., audit reports) and permission for the banks' supervisor to access, directly or via the supervised bank, documentation, data and any other information related to the provision of the activity to the bank."* The requirement for supervisors to have access to information about third parties via the bank appears to be novel compared to the POR and PSMOR.

- CP25 Additional criteria, Section (2)*: "The supervisor assesses concentration risk-related arrangements, and potential systemic risks arising from the concentration of services provided by specific service providers to banks within its jurisdiction."* This appears to be the addition of a new criterion for supervisors to consider potential systemic risks from the concentration of services by service providers, which is not an expectation within the POR or PSMOR.

While we broadly support a heightened focus on third-party risk management in the BCBS standards and Core Principles –which aligns with supervisory trends in many jurisdictions, work at the global level by the Financial Stability Board ("FSB")[6] and efforts by firms themselves[7]— these additions introduce new expectations, which could impact contractual terms (in the case of supervisory access to data) or have unclear implications for individual firms. In the case of Essential Criteria Section (9)(h) on supervisory access to data about third parties, more information would be helpful on what criteria supervisors might apply to go beyond a bank's controls and reporting to access specific data about third parties.

In terms of Additional Criteria, Section (2), we agree that financial authorities are best placed to identify and monitor system-wide concentration risks, specifically from unregulated third-party service providers, as individual firms cannot. However, more information is needed on what a supervisory assessment of potential systemic risks arising from the concentration of services provided by specific non-regulated service providers could imply for supervisory expectations on how individual banking institutions manage their own exposure to such third-party service providers considered systemically important. It is important that individual banks have flexibility to determine their own risk tolerance with respect to concentration risk of third-party service providers. Individual banks would instead find it extremely helpful to receive information and analysis about potential systemically important non-regulated third-party service provider concentrations within the financial system; this could be an input into the bank's own risk assessment of its exposure to third parties. The IIF has recommended in a recent comment letter[8] that the FSB and other financial services standard setting bodies (including the BCBS) could play a role in mapping concentrations at the global level that may give rise to systemic implications.

We appreciate the clarity provided in the Essential Criteria, Section (9)(f) regarding contingency planning and development of exit strategies to ensure operational resilience in the face of service provider failures

[6] IIF Response to FSB Consultation on Third-party Risk Management (August 2023).

[7] Financial institutions have long taken into account concentration risk (and other risks) related to their third-party service providers as part of their third-party enterprise risk management programs and have measures in place to both assess and mitigate these risks. Concentration risk is not new to financial institutions (e.g., risks associated with the use of financial market infrastructure) and has been managed effectively by the financial sector.

[8] IIF Response to FSB Consultation on Third-party Risk Management (August 2023).

or disruptions. However, we would like to emphasize the importance of distinguishing between near-term disruptions and disorderly exit, and long-term orderly exit from a service provider relationship. The differentiation would enhance the utility of the principle in guiding risk management policies that account for both near-term disruptions addressed as part of resiliency plans, and long-term processes managed through effective exit strategies. From a supervisory standpoint, this distinction is critical for assessing an institution's ability to maintain the continuity of critical operations and demonstrating operational resilience in the event of either scenario.

3. Systemic Risk and Macroprudential Aspects of Supervision:

The Associations believe that applying a system-wide macro perspective to the supervision of banks to assist in identifying and analyzing systemic risks and taking pre-emptive action to address them has been well documented as an imperative pillar of financial stability and one that is supported by the industry. In particular, the focus of the Consultation on updating the Core Principles in relation to cooperation and collaboration both domestically and internationally, between the relevant authorities with responsibility for banking supervision and macroprudential policy financial stability (CP3) and the focus on home-host relationships (CP13) is important.

Home-host supervisory cooperation has specifically been considered essential to a well-functioning cross-border financial system. However, financial institutions continue to experience a broader trend towards diverging home-host standards and approaches. These can include local supervisory measures and ring-fencing extraterritoriality, obstacles to cross-border cooperation and information sharing, and expanding host country requirements. Such divergence can create greater separation between the local entity and its financial group impacting matters of stability and can generate financial and operational inefficiencies which reduce the capacity of firms to serve both domestic and international customers.[9] At the same time, inter-supervisory cooperation at a jurisdictional/domestic level is also vital to a well-functioning system where engagement across supervisors is prioritized to achieve effective and efficient oversight.

As such, a continued focus on cooperation *and* coordination amongst supervisors - and communication with financial institutions - is a key standalone principle across the Consultation which will help ensure effective consolidated supervision, especially for global financial institutions as well as the appropriate supervision for local operations of such institutions. This cooperation and coordination between relevant authorities – as well as a focus on micro and macro prudential oversight and avoiding any overlap in those requirements - is necessary to ensure adequate supervision and to avoid an excessive operational burden on regulated entities. While these concepts are reflected to an extent in the Core Principles, it is our understanding that they are not always put into practice operationally across jurisdictions and they should be strengthened via revisions set out in the Consultation.

Information sharing is one way to improve such outstanding issues for supervisory cooperation and coordination. The establishment of good functioning supervisory colleges or information sharing mechanisms is of course of utmost importance. However, a more fluent relationship between relevant supervisors - including cooperation outside the supervisory college structure through day-to-day communication - would also be helpful. Such enhanced cooperation would not introduce a novel concept *per se,* but strengthen the desired supervisory outcomes envisioned within the construct of the Core Principles.

[9] For further information, please see: IIF, *How Fragmentation is Continuing to Challenge the Provision of Cross-Border Financial Services: Issues and Recommendations*, March 2023:
https://www.iif.com/portals/0/Files/content/32370132_iif_scer_market_fragmentation_vf_03_02_2023.pdf

Furthermore, it would be helpful to connect concepts of information sharing in relation to supervisory cooperation throughout the Core Principles. To cooperate successfully across the priorities outlined in the Consultation, there needs to be constant and real-time collaboration which is more efficient for both authorities and for the banks themselves leading to access to broader and faster actionable information to improve financial stability.

For example, CP1(7) states that *"The supervisor has access, whether directly or through the supervised bank, to all necessary information for conducting such a review irrespective of where it is available."* The introduction of this text, however, may be difficult to implement due to legal impediments on information exchange, particularly on a cross-border basis. A further connection should be made to CP 3(3) and CP 3(4) regarding inter-supervisory authority information sharing and the CP13 concerning home-host relationship cooperation to emphasize the need for adequate mechanisms on supervisory cooperation on access to information on an international basis. For cross-border financial institutions in particular, the pivotal role of the consolidating supervisor regarding access by local authorities to group level information should be emphasized and the principle of such access on a strict "need to know" basis should be promoted.

Ultimately, information sharing, cooperation, and coordination should facilitate host supervisors' ability to take comfort from certain groupwide processes and systems, which also benefit the local entity. This should preclude the need for local versions of such processes and systems, along with the need for certain duplicative local governance and other capabilities in relation to those processes and systems. This would materially improve the ability of global financial institutions to more effectively manage and control their operations on a consolidated, global basis, and therefore reduce risk to the benefit of both home and host jurisdictions. To realize these benefits of information sharing, cooperation, and coordination, we believe that Essential Criteria 7 and 9 of CP13 could be improved so that host supervisors take account of firmwide governance and controls and recognize that capabilities provided from elsewhere in a financial group benefit from those firmwide approaches. Rather than focusing purely on risks, there should also be recognition of the benefits of being part of a group.

Lastly, and separately, in relation to the supervisory approach under this section of the Consultation, CP8(5)(c), uses the term "common behaviors" and we believe this would benefit from additional clarity, as the determination of "behaviors" rather than "actions" may lead to issues of jurisdictional interpretation. The intention of sub-section (c) more generally raises questions relating to the monitoring of potential commonalities across banks' business models leading to potential financial instability. The purpose of these revisions should be made clearer in the drafting.

4. New Risks:

a. Climate-related Financial Risks

The Associations welcome the incorporation of the BCBS *Principles for the effective management and supervision of climate-related financial risks ("BCBS Climate Principles")* into the revised Core Principles and support the Committee's goal of promoting a principles-based approach to enhancing supervisory practices and banks' risk management in relation to climate-related financial risks ("CRFR"). Climate-related risks are potential risk *drivers* that interact with the financial risks that banks manage (such as credit, market, operational, liquidity or legal risks), rather than a new risk type *per se*. As such, the management of physical and transition risk drivers is generally incorporated into a bank's existing wider

risk management framework. This is how the BCBS itself has described that climate-related risk drivers should be captured within the Basel Framework.[10]

While it is helpful for BCBS to include footnote references to the BCBS Climate Principles, we question the number of explicit references to "climate-related financial risks" throughout the revised Core Principles, which may create confusion about the fact that climate-related risks are a *risk driver,* rather than a *new risk type*. For example, CP15 on Risk Management includes an explicit reference to CRFR in the first sentence of this broad principle.[11] The explicit identification of climate-related risks may also place outsized weight on these considerations relative to the broad spectrum of risks that banks must consider. For example, CP8 on the Supervisory Approach notes that *"The supervisor considers the macroeconomic environment, climate-related financial risks and emerging risks in its risk assessment of banks."* This particular reference specifically names climate-related financial risks but not the major traditional risk types or other risk drivers.

As commented in the IIF's 2022 response to the BCBS Consultative Document on the BCBS Climate Principles[12], supervisory engagement, risk management guidance, disclosure, and scenario analysis are core tools that supervisors can use to approach CRFR. We have welcomed a global principles-based approach in these areas to strengthen coordination and harmonization of supervisory efforts across jurisdictions, which itself would support progress on CRFR management. Inclusion of CRFR in the Core Principles should hopefully provide supervisors across the world with a strong foundation for coordinated and harmonized approaches to engaging with banks on their management of CRFR, while providing flexibility for the specific circumstances of jurisdictions and individual financial institutions. The introduction to the Core Principles notes that: *"Both bank and supervisory practices may consider climate-related financial risks in a flexible manner, given the degree of heterogeneity and evolving practices in this area."* This important observation is also recognized throughout the BCBS Climate Principles[13], which are cross-referenced in the revised Core Principles. Many banks are taking action and continuing to enhance their approaches to the measurement and management of CRFR; a variety of practices can be appropriate to do this, and banks often leverage their current risk management frameworks, which vary. The Associations' therefore support this message in the Core Principles.

An aspect of the proposed additions which would benefit from greater clarity in the final text relates to expectations about the time horizons over which CRFR are assessed in various contexts. We agree with the notion set out in the introductory material that climate-related risks can materialize over *"varying time horizons"* which can "*go beyond [the] traditional capital planning horizon.*" However, it is essential that supervisors ensure an appropriate distinction between those material risks which could materialize over – and be relevant within – the capital and liquidity planning time horizons, respectively (which themselves differ in length), and those medium to longer-term risk factors which could potentially affect business strategy or inform long-term analysis, but which are not material to firms' current risk exposure or risk profile.

Consistent and clear references to time horizons are important as climate-related risks that could materialize over decades would not be appropriate to take into account when setting capital requirements – which are intended to be a cushion against unexpected losses that could occur in the near

[10] BCBS 2021: "*Climate-related risk drivers and their transmission channels*"

[11] *"The supervisor determines that banks have a comprehensive risk management process (including effective board and senior management oversight) to identify, measure, evaluate, monitor, report and control or mitigate[28] all material risks (including, but not limited to, climate-related financial risks and emerging risks assessed over relevant time horizons) on a timely basis and to assess the adequacy of their capital, their liquidity and the sustainability of their business models in relation to their risk profile and market and macroeconomic conditions."*

[12] "IIF response to BCBS Consultation on Principles for the Effective Management and Supervision of Climate-related Financial Risks" (February 2022).

[13] In the Introduction, Principle 6, Principle 7, Principle 17, Principle 18: https://www.bis.org/bcbs/publ/d532.pdf.

term. Principle 5 in the *BCBS Climate Principles* states that only *"risks assessed as material over relevant time horizons"* should be included in the internal capital adequacy assessment process (ICAAP) and the internal liquidity adequacy assessment process (ILAAP), respectively. This same language is reflected in the footnotes to CP15, Essential Criteria, Section 5 of the revised Core Principles.

However, in CP8 (Essential Criteria, Section 1) and CP26 (Essential Criteria, Section 1) in reference to banks' risk profiles, the Principles state that *"the time horizon for establishing a forward-looking view should appropriately reflect climate-related financial risks and emerging risks as needed."* In our view, the language used here could be read to imply that the forward-looking view of a firm's risk profile should reflect a longer-dated time horizon which may go beyond a firm's risk exposures and financial resource planning horizon. To ensure clarity on this important issue, we suggest amending the time horizon references in CP8 and CP26 to align with the language used in CP15 to state that the forward-looking view should "incorporate risks which are assessed as material over the relevant time horizon," and should further clarify that the time horizon should be relevant to the application – for example, relevant to the capital or liquidity planning horizon.

Another area that would benefit from greater clarity are references to climate scenario analysis and climate stress testing in CP15 (footnotes 31 and 34). As the BCBS has set out, there are important differences between scenario analysis and stress testing, which affect their uses, designs, and potential applications in a prudential context. Specifically, the Associations consider climate scenario analysis a forward-looking risk measurement tool to assess the potential for climate-related risk drivers to give rise to financial stability or institution-specific financial risks under plausible medium to long-term scenarios. Climate stress testing, however, is the assessment of a financial institution's balance sheet resilience, or financial system-wide resilience, to climate-related risks that could plausibly crystallize over the near-term business planning horizon. It would be helpful for the final Core Principles to include a clear description and delineation of the two tools in a climate context, as was included in the BCBS Climate Principles document.

We would further emphasize that both climate scenario analysis and climate stress exercises (which are different, as just described) pursue fundamentally different objectives than prudential stress testing exercises – where the latter are designed to test resilience against a historically large and short-term shock, use established data and methodologies, and measure specific impacts based on established indicators and timeframes. Due to the currently significant limitations in terms of data and methodologies, and the necessary simplifying assumptions employed to feasibly undertake climate scenario analysis or climate stress testing exercises, the results of such exercises may be unrealistic or uncertain, and so special care should be taken when interpreting or applying their outputs. As such, climate scenario analysis and climate stress testing exercises should continue to be clearly differentiated from traditional supervisory stress testing and should not have capital or other regulatory implications.

In addition, footnotes 31 and 34 start with the modifier "where relevant"[14] which could be open to different interpretations, and potentially different assessments across supervisory authorities, as to whether CRFR is relevant enough to a firm that it should be included in scenario analysis and stress testing. The final Core Principles should make clear that this criterion would be linked to the firm's own materiality assessment of CRFR.

On the topic of capital adequacy, we support the fact that CRFRs are not explicitly referenced within CP 16, which is aligned with the BCBS's analysis and recommendations to date. There is no evidence of

[14] Fn. 31: "Where relevant, scenario analysis should reflect climate-related financial risks and emerging risks. Scenario analysis should consider a time horizon which is appropriate to the risk being analyzed." Fn 34: "Where relevant, stress testing should reflect and incorporate climate-related financial risks and emerging risks assessed as material over relevant time horizons."

system-wide solvency concerns that would warrant a redesign or recalibration of capital requirements due to climate-related factors.[15] As noted in Section 1 of this letter, a reference to sectoral capital requirements has been added to CP16 (Additional Criteria, Section 3). It is essential that sectoral capital requirements are only used after an evidence-based cost-benefit analysis and only if it is demonstrated that banks are exposed to a material risk which is not already reflected elsewhere in the Pillar 1 or Pillar 2 risk management and capital frameworks. This is necessary to avoid introducing unintended consequences with that tool.

In the case of CRFR, IIF research and analysis[16] has shown that Pillar 1 capital requirements are not warranted and should not be pursued at present, considering that (i) supervisory climate scenario analysis exercises have not shown there to be solvency risks to the banking sector due to CRFR, (ii) Pillar 1 requirements contain mechanisms that will already capture aspects of climate-related risk drivers (such as through IRB approaches, credit ratings and the accounting regime), and (iii) there are significant methodological issues associated with amending the design of Pillar 1 requirements for CRFR such as those related to the time horizon. Finally, BCBS members should not use capital requirements, including sectoral capital requirements, for non-prudential reasons such as to support specific climate goals.

Lastly, we see the potential for a link to be made between the reference to risks around banks' business model sustainability in CP8 (Essential Criteria, Section 1) which has been newly added in these revisions to the Core Principles, and a bank's response to climate change and the net zero transition, for example through transition planning. We would ask the BCBS to clarify if it is indeed their intention to make this connection through the revisions to the Core Principles. If so, it is essential that separate and specific public consultation is undertaken on any specific expectations in that area for transparency.

Transition planning is a nascent practice, with members of the public and private sectors currently exploring its role and characteristics. Transition planning is a dynamic business exercise to operationalize a firm's strategic targets and commitments to achieve its low carbon goals, with interim milestones. Many firms view it as an element of long-term business strategy. For financial institutions, transition planning metrics and targets may relate to certain financing activities, plan execution and portfolio emissions. Importantly in the prudential context, transition planning and climate risk management are distinct processes that should not be conflated. Given that business model sustainability is referred to as part of CP15 on the Risk Management Process, it is important that strategic business planning and day-to-day risk management, including for CRFR, are not conflated in supervisory discussions.

b. Digitalization of Finance

Through the proposed revisions, changes have been made to CP1 (Responsibilities, Objectives, and Powers) to reflect the importance of cloud service provision, and there have been significant changes to CP25 (Risk Management) relating to digitalization and new technologies.[17] There are also other changes that have some relevance to digitalization. Our comments on these issues reflect the following points:

i. CP1 (Responsibilities, Objectives and Powers)

The key changes to CP1 relevant to digitalization relate to ensuring regulatory access to data that may be held in service providers (in particular the insertion of new language in CP1, essential criteria (5) and (7)).

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[15] The latest evidence was discussed at length in "Climate and Capital: Views from the Institute of International Finance" (July 2022); there have not been significant updates to the evidence basis at the global level since the time of that publication.
[16] Ibid.
[17] We note changes to CP25 are also covered in the context of our comments around Operational Resilience in Section 2 of this letter.

Broadly speaking, we consider that these changes appropriately recognize the increasing importance of third-party service providers, including cloud service providers, in the modern banking landscape.[18]

As to Essential Criteria (5) and (7), these criteria can be fulfilled with regard to internationally active banks or groups including banks, only if foreign laws do not prevent access by the supervisor to the relevant records or necessary information to conduct the supervisory tasks referred to there. The Essential Criteria do not as yet speak to the provision of adequate gateways to enable adequate information sharing to take place. We would therefore suggest inclusion of an additional criterion as follows:

> *(8) Locally applicable laws and requirements do not prevent access by foreign supervisors to whom the Core Principles Apply, to records or necessary information concerning local operations, branches, or affiliates, where strictly necessary to enable them to discharge the powers or functions referred to in these criteria.*

If necessary, that could be added as an additional criterion, but we would advocate that its importance is such that it should be seen as essential.

It is noted also that the definition of "service providers" in paragraph 10.1(20) "includes third parties, intragroup entities and (if applicable) other parties further along the supply chain". In our view, it should be clarified whether other parties are included in Essential Criteria (5) or not.

ii. CP25 (Operational Risk and Operational Resilience)

CP25 has been largely re-written and is considered further under issues concerning operational resilience in this letter.[19] We note here, however, that there is now much more detail on Information and Communications Technology ("ICT") risk management, and also on the desirability of ICT infrastructure for managing operational risk. The key section from a digitalization perspective is mostly new language in Essential Criteria (6) and (9). The topic of concentration risk among cloud service providers is covered in two "Additional criteria" to Principle 25, and again we are broadly supportive. Specific comments on Essential Criterion (9) and Additional Criterion (2) are contained in Section 2 of this letter.

iii. Fintech

There is reference to the BCBS *Sound Practices: Implications of fintech developments for banks and bank supervisors* (2018) in footnotes to CP 1, 8, 10, 15, and 25, which do not otherwise mention fintech. We believe it would be useful to clarify the relevance of those Sound Practices to the Core Principles in some way, perhaps by expanding on the footnotes.

5. Non-Bank Financial Intermediation:

The Associations agree that financial intermediation has evolved significantly since the last review of the Core Principles and that it is important to be alert to the risks arising from the activities of non-bank financial institutions ("NBFI") and their potential impact on the banking system. Recent episodes have shown that NBFIs can amplify stress in the wider financial system, especially when their activities give rise to liquidity mismatches and as a result of the higher levels of leverage that some NBFIs maintain.

It is important, however, that the revisions to the Core Principles focus on the impacts on the banking system from NBFI activities rather than on a broader focus on NBFI vulnerabilities, which is work that is

[18] We also outline further commentary in relation to CP1 and third-party service providers in Section 7 of this letter.
[19] Section 2 of this letter.

being undertaken in various workstreams of the FSB. NBFI vulnerabilities should be addressed via tailored and proportionate measures applied to the specific types of institutions that give rise to the vulnerabilities; that is, measures should not be applied broadly to the entire NBFI sector or to other companies in the financial services sector (*e.g.,* banking organizations).

It is also important to acknowledge the diversity of the NBFI sector and the fact that some NBFIs (*e.g*. (re)insurers) are comprehensively regulated. A focus on the unregulated NBFI market participants is appropriate and risk focused. The BCBS should be careful to differentiate between the impact on the banking sector of the activities of regulated NBFIs, including money market funds, open-ended funds and (re)insurers, and the impact on the banking sector of the activities of unregulated or less regulated NBFIs, such as hedge funds and family offices. If the BCBS identifies any potentially destabilizing impacts on banking organizations from the activities of regulated NBFIs, it should engage with the FSB and the standard setting bodies that are responsible for the establishment of high-level standards for the sector in order to discuss ways in which those negative impacts could be addressed.

A focus on the 'narrow measure' of NBFI is appropriate as it targets the features that give rise to the potential for heightened risks to the banking sector arising from specific activities conducted by some NBFIs, and specifically:

- The narrow measure reflects an activity-based "economic function" ("EF") assessment of risks, and includes the following elements:
    - Collective investment vehicles with features that make them susceptible to runs (EF1)**.**
    - Loan provision that is typically dependent on short-term funding (EF2)**.**
    - Intermediation of market activities dependent on short-term funding (EF3)**.**
    - Insurance or guarantees of financial products (EF4).
    - Stand-alone securitization-based credit intermediation vehicles (*i.e.* other than those used for banks' own transactions or consolidated on the balance sheet of the bank) (EF5).

With respect to CP8, activities outside of the regulatory perimeter may not necessarily constitute regulatory arbitrage. Therefore, it is important to determine whether particular NBFI activities warrant regulation and for the appropriate financial authorities to apply any regulation in a risk-based and proportionate manner.

6. Risk Management Practices:

The Associations agree that in reflecting evolving risks and broader medium/long-term trends, it is critical for a sound risk culture to be in place at financial institutions. Maintaining strong risk management practices is a key priority for the financial services industry. We also see the potential for a link to be made between business model sustainability, which has been newly added in these revisions to the Core Principles, and a bank's response to climate change and the Net Zero transition - for example through transition planning - as noted further section 4 (a) of this letter.

More broadly, we generally agree with the concepts within CP14 on corporate governance and the proposed amendments which give greater emphasis to corporate culture and values, ensuring that bank boards have appropriate skills, diversity, and experience, and promoting board independence and renewal. Alignment with the Committee's *Guidance on Corporate Governance Principles for Banks* is welcome; however, we note that it remains important to ensure these concepts indeed remain principles-based on a global basis rather than overly prescriptive when addressed by the revisions in the Consultation. Culture and governance issues need to consider regional and domestic specificities best aligned to the actualities of jurisdictional experience and capacity, whilst maintaining a high standard to protect the integrity of the financial system.

In addition, we note the following aspects of the revisions throughout the consultation where clarity or adjustment would be warranted in relation to corporate governance whilst ensuring a principles-based approach is upheld and unintended consequences and/or ambiguities are addressed:

- CP14 adds corporate culture and values, strategic oversight, and the suitability assessment process to the exemplary list of topics to be covered by robust corporate governance policies and processes. However, it is important to be cognizant of issues that could arise from such strengthening, including reduced capacity for decision-making, innovation, responsiveness, and adaptability with potential unintended consequences arising for customers and, thus a less prescriptive approach should be considered.
- CP14(3) adds a number of requirements regarding the structures and processes for establishing the Board of Directors of a bank. However, we believe that ambiguities in this principle could lead to misinterpretation in some specific ways and should be clarified. For example, it is unclear what is meant in practical terms by the requirement that Board membership must be "regularly renewed" and how that is interpreted in implementation. The term "sufficient independence" for non-executive directors is also undefined and ultimately should be adaptable to accommodate differences in regional norms and entity types. Provided the independence requirements are met at the parent level, Board composition of subsidiary entities may differ.
- Under CP23(2) the Board must oversee management to ensure policies and processes for management of interest rate risk are fully integrated into the bank's overall risk management process. We believe it should be clarified that the Board's oversight function can be delegated to a Board Committee, rather than remain the responsibility of the full Board.

Regarding CP29, we strongly support proposals to better align requirements regarding the abuse of financial services with the latest Financial Action Task Force ("FATF") recommendations. Inconsistencies in the application of anti-money laundering and countering the financing of terrorism ("AML/CFT") measures and broader anti-financial crime matters across jurisdictions continue to impede efforts to prevent and mitigate illicit financial flows. Rules, along with penalties for non-compliance, that are generally congruous domestically and internationally in line with the risk-based approach will make it harder for criminals to engage in regulatory arbitrage, exploiting gaps in financial crime protections in one jurisdiction. This would help eliminate one of the incentives criminals have to channel their operations through jurisdictions they know are less resilient than others.

7. Other Issues:

In addition to the specific points raised in previous sections, the following areas would also warrant further attention by the Committee as the revisions are finalized.

- The revisions under CP1 concern the responsibilities, objectives and powers that reinforce supervisory controls to ensure that competent authorities have access and can act in relation to any concern they have on any individual bank or the banking system. Nevertheless, we find that it would be useful if the process for when an issue of concern is identified is better defined in all its different phases. It would be helpful, for instance, to emphasize that it is part of the supervisor's duties to make clear in a timely manner when the supervisory review on an issue of concern is finalized in order to ensure the regulated entity can adjust the resources allocated to such concerns once they have been resolved.

- With regards to CP1(5), the supervisor has the power to: *(a) have full access to banks' and banking groups' boards, management, staff and records (including records that are held by service providers and may be accessed either directly or through the supervised bank):* We understand the need for the supervisor to have access to information that is in the hands of key/strategic third party service providers, however we think this activity should, wherever possible, be channeled through the supervised bank. Given that the supervised bank is in permanent contact with the supervisor, this solution seems more efficient than requesting it directly from the third-party service provider. The same concept arises under CP1(7), where supervisor should access information regarding review of the parent company and of companies affiliated with the parent company wherever possible through the supervised bank.

  More broadly, however, CP1(5), footnote [3] also refers to supervisors having full access to individual members of the board. It should be clear that this may be inconsistent with the principle of collegiality set under corporate laws of certain jurisdictions.

- Under CP2, the changes introduced regarding the independence, accountability, resourcing, and legal protection for supervisors are in line with a higher degree of transparency from the supervisor and we welcome the specific reference to the supervisor regularly having to communicate its supervisory priorities publicly and the supervisor clearly defining its allocation of responsibilities within the organization as well as the delegation of authority for particular tasks or decisions.

  However, the term "set prudential policy" added to the text concerning supervisory discretion under CP2(2) can be read as expanding this principle beyond the remit of the Core Principles. The mandate of the supervisor is determined by legislative or similar authority so that the supervisor's "full discretion" may be exercised only within the boundaries of this mandate. As such, it should be clear in the final revisions that such discretion is applicable only within the legal mandate of the supervisory body at jurisdictional level.

  Under footnote [5] of CP2, the immunity of the supervisor's staff is extended to *"external providers"* without any restriction, which may lead to abuse. The revisions should also clarify that such an extension of immunity can only apply if external providers are subject to the same obligations and duty of confidentiality as the supervisor's staff.

- We note that under CP9(4), the sentence which states *"The supervisor communicates its findings to the bank as appropriate and requires the bank to take action to mitigate any particular vulnerabilities that have the potential to affect its safety and soundness"* has been deleted. The supervisor does normally communicate its findings and it is essential for banks to receive this information. Therefore, the deletion may cause uncertainty in implementation and should be restored.

- CP9(11) includes the sentence, *"The supervisor may use independent third parties, including external experts, but it cannot outsource its prudential responsibilities to third parties."*… and a series of criteria are mentioned that supervisors must consider when third parties are used. We believe confidentiality should also be considered when hiring/using third parties that will most likely be exposed to sensitive information.

- With respect more broadly to CP9, we believe the Committee should clarify that any benchmarking analysis (such as envisioned horizontal peer reviews) should not result in supervisors influencing the business models of their supervised banks towards a conceptual target which could lead to a lack of diversification in the banking landscape. This could lead to unintended concentration features which may enhance systemic risk and precipitate further deleterious consequences.

- We believe the use of the term "effective" or "effectiveness" specifically under CP 15, 18, 19 and 26 could lead to subjective and divergent application.[20] The term should be more clearly defined in line with the overall principles to avoid ambiguity in the approach taken during implementation. Further, the term *"and effective in addressing conduct that potentially results in losses"* under CP 14(7) should be reevaluated or removed. We consider this to be redundant with *"prudent risk-taking"* in the context of this provision and could lead to uncertainty in interpretation.

- Under CP 26(4), it would be helpful to retain footnote [82] to explain what internal audit function means in practice for the purposes of the Core Principles.

- With regards to the concept of Proportionality outlined in Sections 02.9 to 02.13 of the Core Principles, we believe proportionality must also be exercised with proper reflection on materiality and it is important that supervisors have the ability to concentrate on material risks, whether within a given institution or across the banking system, beyond the standard indicators of size or complexity that are typically used to inform proportionality.

- Lastly, since 2012, robust recovery and resolution frameworks have been developed and implemented which make for a safer and sounder global financial system and it is a positive development that recovery and resolution is now further embedded in the Core Principles. Nevertheless, we believe there should still be better differentiation between resolution models

[20] CP 15 Risk management process: Essential criteria: (1) … the board establishes an effective ~~suitable~~ risk appetite statement and framework…; CP 18 problem exposures provisions and reserves: Essential criteria: (4) The supervisor determines that banks' credit loss provisions and write-off methodologies and levels are subject to an effective review and validation process conducted by a function independent of the relevant risk-taking function; CP 19 concentration risk: Essential criteria: (3) […] The supervisor determines that banks' credit loss provisions and write-off methodologies and levels are subject to an effective review and validation process conducted by a function independent of the relevant risk-taking function; and CP 26 internal audit and control: Principle … appropriate independent[73] internal audit, compliance and other control functions to test adherence to and effectiveness of these controls as well as applicable laws and regulations.

in the final revisions by the Basel Committee, for example in how the principles reference a Single Point of Entry ("SPE") versus a Multiple Point of Entry ("MPE") resolution strategy.