



The Arab Committee on Banking Supervision

Origin and Purposes



June 2003



Arab Monetary Fund

The Arab Committee on Banking Supervision Origin and Purposes

June 2003

Contents

<u>Contents</u>	<u>Page</u>
Preface	3
Origin of the Committee	3
The Purposes of the Committee	5
Papers and Recommendations Issued by the Committee.....	9
The fourth meeting	
- The Requirements of Banks' Internal Control	11
- Banks' Accounting Disclosure.....	12
The fifth meeting	
- Policy of Credit Classification and Methods of Calculating Loan Loss Provisions	12
The sixth meeting	
- Credit Concentration.....	13
- Bank Liquidity	14
The seventh meeting	
- The Appointment and Responsibilities of External Auditors	14
- Banks' Management Officials.....	15
The eighth meeting	
- Bank Licensing	15
- Risk Concentration	15
The ninth meeting	
- Deposit Insurance Schemes	16
- Exchange of Information between Supervisory Authorities	16
The tenth meeting	
- Bank Profitability.....	17
- Principles of Risk Management.....	17
The eleventh meeting	
- Electronic Banking and the Supervisory Framework	17
The twelfth meeting	
- Sound Management of Financial Institutions	19
- The Role of Monetary Authorities in Combating Money Laundering.....	20

The Arab Committee on Banking Supervision Origin and Purposes

Preface

The Arab Committee on banking supervision (ACBS) discharges a vital and effective function of coordination between Arab countries in issues and developments pertaining to banking supervision. At the same time, it represents an active instrument for the exchange of expertise and information between the Arab banking supervisory authorities.

The ACBS stems from and is affiliated to the Board of Governors of Arab Central Banks and Monetary Authorities. Due to this organic link, it submits to this Board working papers drafted by a designated task force on issues of banking supervision for its review. When endorsed by the Board, such papers are then forwarded as guideline recommendations to Arab central banks and monetary authorities that could be applied in accordance with the framework of the regulations and legal systems of each country.

The Arab Monetary Fund acts as the Secretariat of ACBS. In that capacity, the Fund contributes to supporting the Committee's endeavors to achieve coordination in banking supervision issues and to foster the exchange of experiences between Arab countries.

Origin of the Committee

The origin of the Committee's foundation dates back to 1989. On September 15 of that year, the Board of Governors of Arab Central

Banks and Monetary Authorities had to consider in its fourteenth session the implications of the Basle Accord on Capital Adequacy and then the decision of the European Community concerning the single European market for Arab banks. In one of its resolutions adopted during that session, the Board took a decision whereby it requested the Fund and the Union of Arab Banks to explore practical means capable of minimizing the negative impact of the Basle Accord on Arab banks engaged in cross-border operations and on the ability of Arab countries to borrow from international capital markets.

In response to the said decision, a study was prepared under the title “The Impact of the Decision of the Committee on Banking Supervision of the Bank for International Settlements (BIS) regarding banks’ capital adequacy and country categorization”. The study put forth several recommendations. One of these suggested that a committee on banking supervision be created at the Arab level and be entrusted with the mandate of considering methods for measurement of banks’ worthiness, particularly in respect of capital adequacy in light of international standards and the unification of accounting, bank supervision and regulatory standards of Arab countries.

In its fifteenth session held in Cairo on August 28, 1991, the Board of Governors of Arab Central Banks and Monetary Authorities approved the proposals sketched out in the study and called for the constitution of a committee composed of directors of banking supervision in the Arab central banks and monetary agencies and the Arab Monetary Fund. This committee held its inaugural meeting on November 12-13, 1991 during which a number of recommendations were formulated. One of the most important among these dealt with the necessity of having the Committee acquire a permanent character in view of the multiple and evolving requirements of coordination

between methods of banking supervision in Arab countries and the need to develop their systems and legislations.

The Board of Governors of Arab Central Banks and Monetary Authorities decided during its sixteenth session held in Abu Dhabi on September 5, 1992 to endorse the above proposal; and its decision N° (4) of 1992 converted the Committee into a permanent one and requested it to meet at least once every year and to submit its recommendations to the Board for endorsement.

The Purposes of the Committee

In its aforesaid decision, the Board of Governors of Arab Central Banks and Monetary Agencies has defined the mission and tasks assigned to this Committee in the following:

- To monitor the implementation of agreed standards and study any developments having a bearing on the subject.
- To unify the methods of measurement of banks' worthiness and in particular in respect of capital adequacy, taking into consideration the new international standards.
- To review the techniques of banking supervision in Arab countries with a view to reach the implementation of unified banking supervision methods.
- To coordinate the accounting systems of Arab countries and endeavor to unify them in the future in accordance with international accounting standards.
- To update the Arab banking legislations to reflect agreed international standards.

- To strengthen the role of banking supervision, including technical assistance and training of supervisory staff of central banks.
- To coordinate with other regional groupings on banking supervision⁽¹⁾.

It is worth noting that in addition to the above mission and tasks, the Board's decision requested the Committee: (i) to agree on a time schedule for the application of the capital adequacy adopted by the Basle Committee which takes the circumstances of each country into consideration; and (ii) to define the elements of tier 2 capital.

It flows from the preceding terms of reference that the principal work areas of the ACBS, as defined by the Board of Governors of Arab Central Banks and Monetary Agencies, comprise the following:

- **Requirements of compliance with the Basle Committee standard;** included in these is the definition of the elements of tier 2 capital, the agreement on a time-schedule for the application of the capital adequacy rules, the monitoring of implementation of agreed standards, the review of developments related to the subject and finally the coordination with other regional groupings and the Basle Committee in exploring the possibility of and approach to raising the issue of categorization of Arab countries with the Basle Committee.
- **Issues pertaining to the development of banking supervision** through the study of banking supervision techniques followed in

⁽¹⁾ This task was subsequently added to the Committee's original mission by decision N°(5) of 1993 taken by the Board of Governors of Arab Central Banks and Monetary Authorities.

Arab countries with a view to reach unified banking supervision methods compatible with best international practices.

- **Developing and unifying accounting systems** through coordination between the Arab countries in respect of existing accounting standards and systems and their future unification in line with international accounting standards.
- **Aspects of developing banking legislations** and updating them in order to reflect internationally agreed standards.
- **Means of providing training and technical assistance** to help member countries develop their supervisory capacities.

The Committee's elevation to a permanent body and the Board's definition of its work purview have greatly enhanced its status. They turned it into an official Arab party in charge of achieving the above broader scope of purposes which can influence the Arab banking industry in view of its role in unifying banking supervision, legislations, techniques and practices. This, in turn, can contribute, on the other hand, to supporting the efforts and requirements of Arab economic integration.

It is worth mentioning that in its early meetings, the Committee focused its discussions on the requirements of compliance with the Basle Committee's declared capital adequacy standard and its repercussions on Arab banks.

It endeavored to entice monetary authorities to take measures conducive to bolstering the capital of Arab banks. Subsequently, it sought to study banking supervision techniques followed in Arab countries. It proceeded in this upon guidance from the Board of Governors of Arab Central Banks and Monetary Authorities who invited the Committee to study each year two specific subjects and

provide it with recommendations on them for endorsement; over and above its other regular tasks. To that effect, during its third meeting in Abu Dhabi during November 24-25, 1993, the Committee constituted a task force comprising representatives of Jordan, Saudi Arabia, Lebanon, Egypt and Morocco, together with the Arab Monetary Fund. The task force's mission is to prepare papers on the selected subjects which are then submitted to and discussed by the Committee itself. After their review, the recommendations contained in the papers are cleared and forwarded by the Committee to the Board of Governors of Arab Central Banks and Monetary Agencies for its final endorsement. Until end 2002, the Committee generated papers and recommendations dealing with sixteen subjects covering a large number of banking supervision issues.

Further, since the announcement of the Core Principles for Effective Banking Supervision by the Basle Committee in 1997, the Committee reviewed the latter and sought to have them implemented by the Arab supervisory authorities and to provide Arab countries with support to assist them in adapting their supervisory practices to those principles.

The Committee's members have been keen on continuously briefing the Committee on progress achieved in terms of implementation of those and of related principles. The discussions between the Committee's members, in that regard, offer valuable opportunities for the exchange of experience and expertise between Arab countries in respect of the application of the said principles while taking into consideration their compatibility with the supervisory legislations and systems prevailing in each country.

In addition, the Committee pays particular attention to the technical training aspect as a means for the enhancement of human resource capacity of the supervisory authorities in the member countries. In

that connection, it has requested the Fund in its capacity as its Secretariat to hold courses for the benefit of employees staffing the banking supervision sector. From that perspective, the Secretariat has proceeded through the Fund's Economic Policy Institute to regularly organize every year training courses for those officials. Those activities benefited from the cooperation and contribution of the Basle Committee and many regional and international institutions as well central banks of advanced countries whose aim is to assist in enhancing the qualifications of the staff banking supervision departments.

The Secretariat also invited a number of speakers and experts-particularly those of the Basle Committee- to brief the Committee's meetings on the latest developments of relevance to the various banking supervision issues. On the other hand, the Committee is mindful that the banking environment and financial instruments and services offered are constantly changing at rapid pace. In view of this, it continuously seeks to develop and adapt its own activities and business to such changes so that it could contribute to achieve its purposes. This is in part reflected in the evolving nature of the subjects discussed by the Committee.

Papers and Recommendations Issued by the Committee

From its fourth meeting in Abu Dhabi during November 26-27, 1994 onwards, the Committee started the practice of preparing papers on a number of requirements, subjects or supervisory standards on which it submits recommendations to be taken into consideration by each member country in accordance with their respective legislations and systems. In drafting such papers and recommendations, the Committee bases its work on comparable international principles and standards especially those originated by the Basle Committee. It is

worth noting that while some of those papers are descriptive and serve to introduce the subject at hand along with highlights of its main aspects, other papers contain explicit recommendations in their closing section. Such papers are prepared by the Committee's task force which meets more than once a year. They are then discussed by the full-fledged Committee and revised to incorporate the ensuing amendments. The revised editions of the said papers are subsequently forwarded to the Permanent Bureau of the Board of Governors of Arab Central Banks and Monetary Agencies. The latter Bureau very often adds its own amendments and submits them as final draft versions to the annual meeting of the Board.

The first subject addressed in those papers dealt with the requirements of bank's internal control and accounting disclosure. Subsequently, papers took up two subjects every year along the following pattern:

- | | |
|---|--|
| The fourth meeting
November 26-27, 1994 | - The Requirements of Banks' Internal Control.
- Banks' Accounting Disclosure. |
| The fifth meeting
November 21-22, 1994 | - Policy of Credit Classification and Methods of Calculating Loan Loss Provisions. |
| The sixth meeting
December 21-22, 1996 | - Credit Concentration.
- Bank Liquidity. |
| The seventh meeting
November 2-4, 1997 | - The Appointment and Responsibilities of External Auditors.
- Bank Management Officials. |
| The eighth meeting
November 2-24, 1998 | - Bank Licensing.
- Risk Concentration. |

- | | |
|--|--|
| <p>The ninth meeting
November 28-29, 1999</p> | <ul style="list-style-type: none"> - Deposit Insurance Schemes. - Exchange of Information between Supervisory Authorities. |
| <p>The tenth meeting
January 8-9, 2001</p> | <ul style="list-style-type: none"> - Bank Profitability. - Principles of Risk Management. |
| <p>The eleventh meeting
January 7-8, 2002</p> | <ul style="list-style-type: none"> - Electronic Banking and the Supervisory Framework. |
| <p>The twelfth meeting
December 22-23, 2002</p> | <ul style="list-style-type: none"> - Sound Management of Financial Institutions. - The Role of Monetary Authorities in Combating Money Laundering. |

For the year 2003, the Committee's task force is working on the preparation of three papers dealing with operational risks, bank's internal rating and consolidated supervision. These are expected to be discussed in the Committee's meeting scheduled to take place in Abu Dhabi in December 2003.

Following is a synopsis of each of the above papers and their main recommendations:

The Requirements of Banks' Internal Control: This paper defined the requirements of internal control and their importance to banks. It highlighted the benefits which this control provides through its role in protecting the bank's assets, enhancing the staff's effectiveness in their adherence to adopted policies, unveiling of violations and errors and minimizing the probability of their recurrence. The paper pointed out that a sound supervisory system requires the availability of certain fundamentals which include the existence of a clear organizational and management structure, a sound accounting system as well as specified instructions manuals spelling out work

procedures and regulations. It also requires the existence of executive procedures which help in exercising such control effectively. Included in these are the segregation between conflicting tasks, delegation of powers, a clear job description and the availability of internal audit services reporting to the management board.

Banks' Accounting Disclosure: This paper highlighted the increasing importance of banks' accounting disclosure and its role in assisting supervisory authorities in discharging their functions in the context of an evolving banking environment and its ramifications. In that respect, the paper focused mainly on the presentation of international accounting standard N0 30 which addresses the disclosure of financial statements of banks and similar financial institutions. It further highlighted the set of mandatory standards which must be observed in order to achieve an effective disclosure of banks' financial statements. Such standards include those pertaining to investment and trading in financial papers, deposits, accounting changes, foreign currencies, subordinated deposits, mortgages, consolidated financial statements, investment in subsidiaries and finally the overall presentation and disclosure.

The paper also contained a detailed description of items related to financial statements which must be published. These items are: the balance sheet, statement of income, expenditures and appropriations and the statement of cash flows. It explained how such statements must be prepared and the details which need to be included and associated explanatory notes. It also pointed out the other main items which banks should, as a minimum, disclose beside the financial statements themselves.

Policy of Credit Classification and Methods of Calculating Loan Loss Provisions: This paper discussed the risks to which banks are

exposed in extending credit. It explained that in order to minimize the effects of such risks, it is indispensable that supervisory authorities put in place rules to govern the extension of credit, its use and its monitoring, the extent of its concentration, the quality of guarantees and information required prior to approval or renewal. The main foundations of such rules are the existence of unified criteria for the classification of assets and transient commitments and the constitution of provisions to meet any shortfall in their value so as to ensure a bank's asset adequacy to meet its obligations.

The paper summarized the basis which banks must follow in categorizing their credits and constituting the necessary provisions. It stressed the need for direct and indirect loans to be periodically classified in the two categories of regular and other irregular credits. In this connection, it defined three types of irregular credits: the substandard, the doubtful and the loss ones. It called for the constitution of specific provisions for each of them. The paper set out for the consideration of supervisory authorities a number of recommendations for credit classification and calculation of their provisions. The most important ones concern the definition of the periodic information that banks must be required to provide regarding regular and irregular credits, together with the provisions constituted for each of them, and the need to request external auditors to assess the adequacy of the available provisions.

Credit Concentration: This paper defined credit concentration as the sum of direct and indirect exposure of a bank towards a single customer or a group of inter-related customers or parties connected to the bank by a proportion equal to or higher than ten percent of the bank's capital base. In this respect, it spelled out the intended meaning defining the relevant customers and parties connected to the bank. It explained the method of measuring these concentrations and called for maintaining a maximum limit of 25 percent of the capital

base for relevant customers and 15 percent for each member of an executive board and directors or relatives and a capping overall 50 percent for all of them combined. It recommended that it becomes mandatory for banks to submit periodic reports on credit concentration to the supervisory authorities. It also called, whenever feasible, for the adoption of the principle of consolidated supervision in monitoring credits granted by overseas branches, parent-institutions and subsidiaries in order to accurately measure the volume of credit concentration.

Bank Liquidity: This paper discussed the bank liquidity concept and its importance for the banking activity. It indicated that it basically relates to the techniques and effectiveness of a bank in the management of its resources in terms of striking an optimal balance between the extent of risk exposure associated with over-eagerness to maximize profits, on the one hand, and the maintenance of asset safety and requirements, on the other. The paper provided details on the calculation of a bank's liquidity ratio and identified the items to be included in or excluded from the calculation of the ratio. The paper concluded, in that regard, with a listing of responsibilities of bank's management and their duty of returning periodically a specific questionnaire on the matter to the supervisory authorities.

The Appointment and Responsibilities of External Auditors: This paper discussed the importance of the external auditors' work. It indicated that the general assembly of a bank is responsible for their selection and appointment. It outlined the professional and ethical responsibilities of the external auditor and his relationship with supervisory authorities. In this connection, it highlighted the need for the auditor to forward to the supervisory authorities copies of all reports he provides to a bank or other information it requests him to obtain.

Banks' Management Officials: This paper sets forth the conditions to be fulfilled by bank management officials and the basis of their relationship with the supervisory authorities. It demonstrated, in that regard, the need to notify to the supervisory authorities the names of appointees or candidates to be members of the executive board and executive managements of a bank .It indicated that the said authorities were empowered to object, within a specified time period, to any of those names.

Bank Licensing: This paper stresses the prime importance of bank licensing which represents an essential pillar of banking supervision. In view of this, it pointed out that the subject deserves careful attention in terms of laying out the conditions and requirements necessary for its regulation. It indicated that it is the prerogative of the licensing authority to spell out the underlying criteria and the standards, which the applicants must fulfill, and to reject the requests, which fail to meet them. Accordingly, the paper discussed all these requirements and relevant considerations in granting a license. These cover the following: the economic feasibility rationale for establishing a bank, the profile of the proposed management, its capital, the list of names of founding shareholders and the distribution of their respective shares. The paper further referred to other additional requirements applicable to cases of licensing foreign banks, such as their mandatory monitoring by supervisory authorities in their country of origin and the non-objection of those authorities to their overseas installation.

Risk Concentration: This paper discussed the key role played by the existence of risk concentration regulating mechanisms in central banks and monetary agencies in assisting banks in taking appropriate credit decisions, as such mechanisms enable banks to determine the overall commitments of any customer towards the entire banking system. The paper addressed the various aspects related to the

establishment of such systems, the nature of the typical information which they generate, the techniques of entering the identities of customers into the systems, the quality of such information and credit classification in the direct and indirect categories. The paper showed that in order for such systems to operate successfully, banks must uphold their commitment to submit, both periodically and when investigating a customer, the requisite information in accordance with the questionnaires specifically designed for that purpose. To achieve this objective, the paper recommended that agreement be reached on a number of points. The latter include: the timing of banks' transmission of information on customers, the method of reporting the said information, the call on banks to use this consolidated information on customers when extending credit and the introduction of a mechanism for updating the information continuously.

Deposit Insurance Schemes: This descriptive paper provided a briefing on the deposit insurance system which can be created by monetary authorities in cooperation with banks as well as on its operating modalities. The paper touched on the technique of the system's administration which involves the obligation of bank's participation in the system, securing the required financing and the limits of coverage without mentioning specific numbers or ratios. It also laid out general rules for placing the system's funds, its duties and obligations upon liquidation of a bank.

Exchange of Information between Supervisory Authorities: This paper focused on the added importance of the exchange of information between the supervisory authorities in an environment of market openness and the expansion of cross-border banking activities. In that respect, it recommended that supervisory agencies closely coordinate their domestic actions in the various constituent components of the financial sector and that they cooperate with their

counterparts in other Arab countries with regard to all information of a supervisory or surveillance nature. It also called on those agencies to be guided by the Basle Committee standards with regard to consolidated supervision.

Bank Profitability: This paper discussed the profitability of banks in light of its relationship with performance and risks. It reviewed that relationship with a particular focus on risk, its measurement and its effects on profits. It also defined the main profitability ratios and the rules for their calculation. The paper invited supervisory authorities to adopt appropriate regulations to govern the analysis of banks' profitability and to relate the latter to the risks to which a bank is exposed.

Principles of Risk Management: This paper emphasized the necessity for banks to draw up a strategy and general principles of risk management. It highlighted, in this regard, the responsibility of a bank's executive board in endorsing such a strategy and risk management policies and in inciting their management officers to take risks on rational grounds since they are in charge of applying the said policies. The paper also stressed the need for designating a risk management committee which is independent from the executive board. It also surveyed the main policies and measures for improving the effectiveness of banks' risk management in terms of reporting responsibilities, or of designating specific officers to be in charge of each type of risk facing the bank and of defining the duties of the risk management department. It also advocated the adoption of a methodology for measuring and monitoring risks along with the implementation mechanisms. Finally, the paper touched on the role of the internal control in enhancing the efficiency of risk management policies.

Electronic Banking and the Supervisory Framework: This paper showed that the rapid changes in the technologies used and the

increased reliance on outsourcing the supply of electronic banking services lead to changes and increases in traditional banking risks. This requires that supervisory authorities issue additional guidelines conducive to strengthening risk management mechanisms associated with electronic banking activities.

In surveying the risks involved, the paper focused on the strategic and operating risks as well as the reputation risks that may arise due to the introduction of electronic banking services. The paper invites the supervisory authorities to take due account, when dealing with this new situation, of the pressing need for having their staff include officers who possess the appropriate knowledge of and adequate experience with the emerging risks and challenges associated with electronic banking operations.

On the other hand, the supervisory authorities must ensure that banks under their jurisdiction are equipped with comprehensive mechanisms, procedures and systems necessary for the management and monitoring of electronic banking risks. In order to attain this, the paper call on the authorities to be guided by the fourteen general principles laid out by the Basle Committee as a pillar and basic instrument at the disposal of the supervisory authorities to use in checking the soundness of bank's dealing with electronic banking issues. These principles fall in the following three categories: (i) the responsibilities of upper management; (ii) issues related to the control of security and operating risks; (iii) matters pertaining to the management of legal and reputation risks.

Finally, the paper addressed issues dealing with cross-border banking operations and described the risks and challenges associated with the likely expansion of such operations through the use of the Internet network. In this respect, the paper invited the supervisory authorities to review the orientation of their existing guidelines and

methodologies covering cross-border banking operations and update them by including issues related to the handling of electronic banking while at the same time strengthening coordination and cooperation with their counterparts in other countries and with relevant international frameworks. Sustained action in that direction will contribute to laying the foundation of principles of supervising such operations and minimizing their risks.

Sound Management of Financial Institutions: This paper showed that supervisory authorities had been paying increasingly greater attention to the soundness of management in the financial and banking institutions. This stems from the realization that there was a close link between the effectiveness of the supervisory function and the existence at the helm of those enterprises of good, competent upper and executive management operating within the framework of an appropriate organizational structure, clear objectives and policies and well-defined duties and responsibilities for all actors involved. In that connection, the paper shed light on the definition of the intended meaning of sound management in banking institutions and the pillars of its success. To that effect, it surveyed the contents and execution of responsibilities and duties of each of the following managerial constituents: i) the executive board and its affiliated committees; ii) the executive management and committees; and iii) the internal and external auditors.

Furthermore, the paper reviewed the role of supervisory authorities in promoting the principles and culture of sound management in those financial institutions under their jurisdiction and verifying compliance in that respect. The paper invited those authorities to ensure that the latter possess a proper organizational structure and an appropriate set of internal control policies and procedures which are necessary for the protection of enterprise assets and the safety of its financial integrity and management stability.

The paper called on the authorities to issue the relevant instructions listing the obligations to be observed by those institutions in this regard. The most important among these instructions are those pertaining to the following: i) the organizational structure of financial institutions and the basis of their design; ii) manuals for the formulation of executive policies and procedures; iii) manuals for the composition of committees and power delegation; iv) manuals on the adequacy and flows of information; v) instructions regarding conflicts of interest and related parties; vi) manuals specifying the role and responsibilities of executive boards towards the supervisory authorities; vii) manuals outlining the role of executive management and responsibilities towards supervisors; viii) manuals for auditing.

The Role of Monetary Authorities in Combating Money Laundering: This paper reviewed the role and responsibility of monetary authorities in combating money laundering. It indicated that a main responsibility in that respect was the issuance of comprehensive guidance and instructions to all financial and banking institutions defining for them the ways to deal with matters pertaining to the combat of money laundering and spelling out their detailed responsibilities in identifying and reporting suspicious cases. The paper further specified that it was the responsibility of the monetary authorities to establish a financial intelligence unit department. The functions of such an entity would be to investigate, compile information and to liaise and coordinate with all other domestic and external parties involved in combating money laundering and to develop the capacities of the supervisory teams in verifying that banks possess effective measures to combat money laundering. In addition, the monetary authorities have an important role in heightening awareness about issues related to combating money laundering among both staff of the financial and the banking institutions and the general public at large.

Copies of publications issued by the Arab Monetary Fund
may be requested from:

Arab Monetary Fund
P.O. Box 2818
Abu Dhabi, United Arab Emirates
Tel. : (+9712) 6215000
Fax : (+9712) 6326454
E-mail: centralmail@amfad.org.ae
Website: <http://www.amf.org.ae>

The Arab Monetary Fund has published the following information pamphlets:

- Arab Monetary Fund - The Lending Activity.
- Contribution of the Arab Monetary Fund to the Development of Arab Capital Markets.
- Arab Monetary Fund - The Technical Assistance.
- Economic Policy Institute - Objectives and Activities.
- The Arab Committee on Banking Supervision - Origin and Purposes.