Core Principles Methodology

Basel Committee on Banking Supervision

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CORE PRINCIPLES METHODOLOGY

EXECUTIVE SUMMARY

1. The Core Principles for Effective Banking Supervision have become the most important global standard for prudential regulation and supervision. The vast majority of countries have endorsed the Core Principles and have declared their intention to implement them. As a first step to full implementation, there should be an assessment of the current situation of a country's compliance with the Principles. Such an assessment should identify weaknesses in the existing system of supervision and regulation, and form a basis for remedial measures by government authorities and the bank supervisors. Such assessments are typically conducted by the countries themselves or by various outside parties.

2. The Basel Committee on Banking Supervision has decided not to make assessments of its own due to a lack of necessary resources; however, the Committee is prepared to assist in other ways, *inter alia* by providing advice and training. Committee members may also individually participate in assessment missions conducted by other parties such as the IMF, the World Bank, regional development banks, regional supervisory organisations and private consultants. "Peer reviews" are also possible, whereby supervisory experts from one country assess another country and vice versa.

3. In order for the assessments to be objective and as uniform as possible, there should be harmonised standards for the fulfilment of the Core Principles. Experience has already shown that the Principles may be interpreted in widely diverging ways, and incorrect interpretations may result in inconsistencies among assessments.

4. With this in mind, at its October 1998 meeting, the Basel Committee took the initiative to have a document prepared for use in compliance assessments. The drafting was done by an ad hoc working group consisting of representatives from Basel Committee member institutions and the IMF and World Bank. The Core Principles Liaison Group, consisting of G-10 and non-G-10 senior supervisors and the IMF and World Bank, was also consulted during the drafting process.

5. The document is structured as follows: the first chapter outlines the background to the Core Principles and explains the need for their timely and effective implementation. It also describes under what conditions assessments should be made, as well as the preconditions for effective banking supervision that should be taken into account when forming an assessment.

6. The second chapter raises a few basic considerations regarding the conduct of an assessment and the compilation and presentation of the results. It notes that the assessor must have access to relevant information, without violating legal requirements for supervisors to hold certain information confidential, and to a wide range of organisations and experts. The chapter emphasises that the assessment must consider a chain of related requirements, which may encompass laws, prudential regulation, supervisory guidelines, on-site examinations and off-site analysis, supervisory reporting and public disclosures, and evidence of enforcement or

non-enforcement. It also emphasises the importance of the supervisory agency having the necessary skills, resources and commitment to implement the Core Principles.

7. The third chapter discusses each Core Principle in detail. All significant criteria which are relevant for compliance are enumerated. Two categories of criteria are used: “essential criteria” and “additional criteria”. The essential criteria are those elements that should be generally present in individual countries in order for supervision to be considered effective. The additional criteria are elements that further strengthen supervision and which all countries should strive to implement. The essential criteria, and to a significant degree the additional criteria, are drawn from the Core Principles document (September 1997) and related Basel Committee papers. The working group has tried not to break new ground by introducing additional concepts or interpretations, although in some cases, particularly regarding the additional criteria, the language and/or substance may be more explicit or detailed than in previous documents.

8. To achieve full compliance with a Principle, the essential criteria generally must be met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the Principle has been achieved through different means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore the additional criteria and/or other measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.

9. By way of example, the Basel Committee includes, as an appendix, the format developed by the IMF and World Bank for conducting their own assessments of the state of implementation of the Core Principles in individual countries.

10. The Committee sees the formulation of this document as an iterative process, with refinements made as experience is gained. Developments of regulatory and supervisory standards and procedures will lead to additions and revisions. Thus, there will be a need to update the document periodically.

CHAPTER I: INTRODUCTION

Objectives of the Core Principles for Effective Banking Supervision

11. The Core Principles for Effective Banking Supervision, developed by the Basel Committee on Banking Supervision in cooperation with supervisors from non-G-10 countries, provide the international financial community with a benchmark against which the effectiveness of bank supervisory regimes can be assessed.

12. The need for strengthening supervision of banks has particularly been stressed as a major priority since it is now widely recognised that weaknesses in banking systems have been at the core of financial crises in many countries over the last decade. As current banking crises affect many countries, both developed and emerging economies, the monitoring of banking systems becomes both more critical and more challenging for supervisors. As a result, and in order to minimise the risk of contagion, developed and emerging countries are being strongly urged to adopt and effectively implement sound supervisory methods.

Endorsement of the Core Principles by the international community

13. The Core Principles were issued by the Basel Committee in September 1997, and endorsed by the international financial community during the annual meeting of the IMF and World Bank in Hong Kong in October 1997. The report of the Working Party on Financial Stability in Emerging Market Economies endorsed the Core Principles and requested that the IMF and the World Bank play a critical role in their implementation. In October 1998, the Group of 22 countries issued its reports on the international financial architecture, and in its report on Strengthening Financial Systems, the Group endorsed several sets of internationally acceptable principles including the Core Principles and underscored the importance of their timely implementation. The International Conference of Banking Supervisors in Sydney endorsed the Core Principles and pledged to actively contribute to their implementation while requesting more comprehensive guidance from the Basel Committee. The request has resulted in this document.

International pressure to swiftly implement the Core Principles

14. As a result of heightened concern about financial sector stability, the community of banking supervisors is under pressure to ensure the effective supervision of banks. In particular, this has been reflected in growing international demands for countries to implement the Core Principles.

15. The Basel Committee recognises that both financial reforms and better banking supervision require broad-ranging and intensive efforts over a long period of time. However, it is of the utmost importance that national supervisory authorities take immediate steps to: i) identify weaknesses in their supervisory system; ii) address the most urgent weaknesses; and

iii) urge public authorities to support fully all necessary measures to strengthen financial sector stability, including the implementation of the Core Principles.

16. As standard setter, the Basel Committee will remain very active in interpreting the current Core Principles, providing training to supervisors world-wide, and disseminating norms and sound practices. The Basel Committee might find it necessary to refine further the Core Principles to ensure that they are not only comprehensive, but also relevant and useful for all countries wishing to apply them. With respect to interpreting or revising the Core Principles, the Committee will be working very closely with non-G-10 countries, as well as the IMF and the World Bank, within the Core Principles Liaison Group.

17. Both the IMF and the World Bank will play an active role in the implementation process. In the context of its surveillance mandate, the IMF will encourage its member countries to comply with the Core Principles, and will work with them in assessing compliance on a case-by-case and priority basis. In the course of its regular operations, the World Bank will encourage its client countries to adopt the Core Principles and will also work with them to assess their supervisory framework against the Principles. Both the IMF and the World Bank will seek to have countries remedy identified weaknesses in their regulatory and supervisory regimes, and will provide technical assistance and training to address such weaknesses on a priority basis. To meet the increasing demands in the financial sector area, both institutions are increasing the number of staff with financial sector expertise.

18. The Basel Committee, the Core Principles Liaison Group, the IMF and the World Bank have an ongoing dialogue to i) coordinate initiatives so that common objectives in this field can be met; and ii) ensure that scarce expert resources are used in the best possible way. Given the challenging objective of strengthening banking supervision worldwide and the scarcity of resources to do so, the above groups are fully aware of the need to closely coordinate their respective activities. These organisations will also utilise resources made available by supervisors world-wide as a means to help countries that ask for technical assistance with the intention of assessing their supervisory systems against the Core Principles.

Initial assessments of compliance with the Core Principles

19. While the process of implementing the Core Principles starts with the assessment of compliance, the assessment is a means to an end, not an ultimate objective in itself. Instead, the assessment will allow the supervisory authority (and in some instances the government) to initiate a strategy to improve the system of banking supervision, as necessary. Assessments of compliance have already been initiated in several different contexts.

20. The Basel Committee initiated in April 1998 a survey on compliance with the Core Principles with a view toward preparing information for consideration at the International Conference of Banking Supervisors in Sydney in October 1998. The Committee distributed a questionnaire to about 140 countries and asked that supervisors undertake a rigorous assessment of their supervisory systems to determine the extent to which the Core Principles were being implemented. More than 120 countries provided the Committee with such self assessments, but the quality of responses was uneven.

21. In the meantime, the IMF and the World Bank initiated a review of compliance with the Core Principles in several countries at their request. Being made for the first time, these assessments provided the opportunity to test both the applicability, clarity and completeness of the Core Principles, and the degree to which an outside assessor could form a view regarding compliance.

22. The preliminary reviews of compliance conducted either through self assessments or by third parties have clearly demonstrated that a harmonised assessment methodology is desirable.

Need for a harmonised assessment methodology

23. The Core Principles were designed to provide general guidance that could apply to various supervisory regimes, allowing some flexibility in the design and implementation of concrete measures. In so doing, the Basel Committee was also aware that national supervisory authorities might misinterpret the Core Principles. In the same vein, the assessment of compliance with the Core Principles by numerous interested parties (e.g., the IMF, World Bank, regional supervisory groups, regional development banks, consulting firms) is likely to result in varied interpretations and possibly inconsistent advice. Although, the results of the assessments may not be made public, it is still important that assessments be conducted in a consistent manner from country to country.

24. In order to achieve the necessary consistency, the Basel Committee pledged to develop a methodology for performing assessments, including detailed criteria for determining compliance. This methodology will not eliminate the need for both the supervisors and assessors to use their judgement in assessing compliance.

Use of the methodology

25. The methodology can be used in multiple contexts: i) self-assessment performed by bank supervisors themselves, ii) peer review conducted for instance within regional groupings of bank supervisors, iii) reviews conducted by private third parties such as consulting firms, or iv) reviews performed in the context of the IMF surveillance or World Bank lending operations.

26. Whatever the context, the following factors are crucial:

- notwithstanding the benefits of a self-assessment, in order to achieve full objectivity, compliance against the Core Principles is best assessed by a suitably qualified **outside party consisting of at least two individuals with varied perspectives so as to provide checks and balances;**

- a fair assessment of the banking supervisory process cannot be performed without the **genuine cooperation of all relevant authorities;**

- the **assessment of banking supervision by non-experts could be misleading** even based on the most detailed checklist; the process of assessing each of the twenty-five

Principles requires a judgmental weighing of numerous elements that only qualified assessors with practical, relevant experience can provide.

- the assessment may require legal expertise in the interpretation of compliance with the Core Principles; these legal interpretations must be in relation to the legislative structure of the relevant country. Also, they may require the advice of additional legal experts which can be sought subsequent to the on-site assessment.

- the assessment **must be in sufficient depth** to allow a judgement on whether criteria are fulfilled in practice, not in just in concept. Laws and regulations need be effectively enforced and complied with. The mere existence of these does not provide an indication that the criteria are met.

Preconditions for Effective Banking Supervision

27. The Basel Committee recognises that effective banking supervision requires a set of preconditions to be in place.[1] While these preconditions are largely beyond the control of the supervisory authority, weaknesses or shortcomings in these areas may significantly impair the ability of the supervisory authority to implement effectively the Core Principles. Hence, the assessors should form a view as to whether these preconditions are in place, as well as the potential problems any shortcomings might entail and whether best efforts are being made to correct these shortcomings. As discussed in the following five paragraphs, the preconditions cover a range of areas, including: (1) sound and sustainable macroeconomic policies; (2) a well-developed public infrastructure; (3) effective market discipline; (4) procedures for the efficient resolution of problems in banks; and (5) mechanisms for providing an appropriate level of systemic protection (or public safety net).

28. The macroeconomic environment and the sustainability of macroeconomic policies are major issues because of their two-way interaction with bank soundness. While the assessment focuses on the adequacy of a country's banking supervisory processes, the assessor should seek to form a view as to whether there are macroeconomic vulnerabilities and risks that have implications for the effectiveness of prudential safeguards or the stability of the financial system. Thus, the assessment of the overall effectiveness of banking supervision and compliance with individual Core Principles should give consideration to the macroeconomic environment. In this respect, it is also important that the assessment take into account the structure of the banking sector and the macroeconomic environment in which the banks operate.

29. The public infrastructure may have a profound impact on the potential to comply with the Core Principles. Perhaps the most important aspect is the existence of a proper credit culture, i.e., an environment that fosters the honouring and enforcement of financial contracts. The credit culture must be built on an adequate body of laws, covering a range of financial issues, including inter alia, contracts, bankruptcy, collateral and loan recovery. But good laws are not enough, they must be supported by a body of ethical and professional lawyers and

[1] See Core Principles for Effective Banking Supervision, Section II.

judges, and a reasonably efficient court system whose decisions are enforceable. An adequate infrastructure also requires that accounting standards approach international best practices, so investors and supervisors can properly evaluate the financial condition of the banks, and the banks can monitor the health of the institutions to which they lend. Accurate financial data requires a professional body of accountants and auditors. Other key considerations in evaluating the public infrastructure are the effectiveness of supervision in other financial sectors and markets, as well as the risks inherent in the payment system.

30. Effective market discipline is based on financial transparency and effective corporate governance; however, the process can be undermined by government efforts to influence commercial decisions, particularly lending operations. Hence, any influence government policies have on lending operations should be as transparent as possible, with government policies published and government guarantees clearly disclosed.

31. Supervisors should have a sufficient and flexible range of procedures to achieve the efficient resolution of problems in banks. The Core Principles note the need for such a range of powers, including responsibility for, or ability to assist in, the prompt and orderly resolution of problem banks.

32. There is a need to ensure that an appropriate public safety net is in place. The key aspects of this safety net may include a lender of last resort facility and/or formal deposit insurance arrangements. While minimum standards for a public safety net have not been agreed, shortcomings in the safety net have implications for banking supervisory practices.

CHAPTER II: SOME CONSIDERATIONS IN CONDUCTING AN ASSESSMENT

33. While the Basel Committee does not have a specific role in setting out detailed guidelines on the conduct, preparation and presentation of assessment reports, it believes there are a few considerations that assessors should take into account when conducting an assessment and preparing the assessment report. In addition, the Committee is providing in the annex, by way of example, the proposed format to be used by the IMF and World Bank in their assessments. Other potential assessors (e.g., regional development banks, regional supervisory groups) may want to consider using this format in their work although this format is just one way of conducting an assessment.

34. First, when conducting an assessment, the assessor must have free access to a range of information and interested parties. The required information may not only include published information such as the relevant laws, regulations and policies, but also more sensitive information, such as any self-assessments, operational guidelines for supervisors, and, where possible, supervisory assessments of individual banks. This information should be provided as long as it does not violate legal requirements for supervisors to hold such information confidential. The assessor will need to meet with a range of individuals and organisations, including the banking supervisory authority or authorities, other domestic supervisory authorities, any relevant government ministries, bankers and bankers' associations, auditors, and other financial sector participants. Special note should be made when any required information is not provided, as well as what impact this might have on the accuracy of the assessment.

35. Second, the assessment of compliance with each Core Principle requires the evaluation of a chain of related requirements, which, depending on the Principle, may encompass law, prudential regulation, supervisory guidelines, on-site examinations and off-site analysis, supervisory reporting and public disclosures, and evidence of enforcement or non-enforcement. It also requires assessing whether the supervisory authority has the necessary skills, resources and commitment to implement the Core Principles. Further, the assessment must ensure that the requirements are put into practice.

36. Third, the primary objective of an assessment should be the identification of the nature and extent of any weaknesses in the banking supervisory system and compliance with individual Core Principles. The assessment should not focus solely on deficiencies but also highlight the achievements. This approach will provide a more accurate measure of the overall compliance with the Principles. The results of such assessments should not be used to grade or rank a supervisory system but rather to develop an action plan that prioritises the improvements needed to achieve full compliance with the Core Principles. It should also indicate the actions and timetable undertaken to address any shortcomings and where a follow-up assessment may be warranted.

37. Fourth, in order to achieve full compliance with a Principle, the essential criteria generally must be met without any significant deficiencies. There may be instances, of course, where a country can demonstrate that the Principle has been achieved through different means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle and therefore the

additional criteria and/or additional measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.

38. Fifth, there are certain jurisdictions where non-bank financial institutions, that are not part of a supervised banking group, conduct some bank-like activities, which represent a significant portion of the total financial system and may be largely unsupervised. Since the Core Principles deal specifically with bank supervision, they cannot be applied to these non-bank financial institutions. However, the assessment report should, at a minimum, mention the activities where non-banks have an impact on the supervised banks and the potential problem situations which may develop as a result of the non-bank activities.

CHAPTER III: CRITERIA FOR ASSESSING COMPLIANCE WITH THE CORE PRINCIPLES

The following set of criteria for each of the 25 Core Principles are listed under two separate headings: “essential criteria” and “additional criteria”. The essential criteria are those elements that should be present in order to demonstrate full compliance with a Principle. The additional criteria are elements that further strengthen supervision and are recommended for improved financial stability and effective supervision. They may be particularly relevant to the supervision of more sophisticated banking organisations or may be needed in instances where international business is significant or where local markets tend to be highly volatile.

The individual criteria are largely based on materials provided in the full Core Principles document (September 1997) and in related Basel Committee papers on sound practices. Where appropriate, the documents have been cited.

It should be noted that, while many of the criteria refer to supervisors having the authority to conduct such activities as setting certain standards and requirements for banks, these can also be contained in laws and regulations. Conversely, where it is mentioned that laws and/or regulations are in place on certain issues, the same effect can, in some circumstances, be achieved through guidelines.

Principle 1: An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision; powers to address compliance with laws as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Note: Principle 1 is divided into six component parts. Four of the component parts are not repeated elsewhere in the Core Principles. However two parts (3 & 4) are developed in greater detail in one or more of the subsequent Principles. For these two, since the criteria will be developed further elsewhere, this section identifies only the most fundamental and crucial ones.

1 (1): An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.

Essential criteria

1. Laws are in place for banking, and for (each of) the agency (agencies) involved in banking supervision. The responsibilities and objectives of each of the agencies are clearly defined.

2. The laws and/or supporting regulations provide a framework of minimum prudential standards that banks must meet.

3. There is a defined mechanism for coordinating actions between agencies responsible for banking supervision, and evidence that it is used in practice.

4. The supervisor participates in deciding when and how to effect the orderly resolution of a problem bank situation (which could include closure, or assisting in restructuring, or merger with a stronger institution).

5. Banking laws are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.

Additional criteria

1. The supervisory agency sets out objectives, and is subject to regular review of its performance against its responsibilities and objectives through a transparent reporting and assessment process.

2. The supervisory agency ensures that information on the financial strength and performance of the industry under its jurisdiction is publicly available.

1 (2): Each such agency should possess operational independence and adequate resources.

Essential criteria

1. There is, in practice, no significant evidence of government or industry interference in the operational independence of each agency, and in each agency's ability to obtain and deploy the resources needed to carry out its mandate.

2. The supervisory agency and its staff have credibility based on their professionalism and integrity.

3. Each agency is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes, inter alia:

   - salary scales that allow it to attract and retain qualified staff;
   - the ability to hire outside experts to deal with special situations;
   - a training budget and program that provides regular training opportunities for staff;
   - a budget for computers and other equipment sufficient to equip its staff with tools needed to review the banking industry; and
   - a travel budget that allows appropriate on-site work.

Additional criteria

1. The head of each agency is appointed for a minimum term and can be removed from office during such term only for reasons specified in law .

2. Where the head of an agency is removed from office, the reasons must be publicly disclosed.

1 (3): A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.

Note: This component of Principle 1 is amplified considerably in the Principles dealing with *Licensing and Structure* (2 to 5), *Prudential Regulation and Requirements* (6 to 15), *Methods of Ongoing Banking Supervision* (16 - 20), and *Information Requirements* (21).

Essential criteria

1. The law identifies the authority (or authorities) responsible for granting and withdrawing banking licences.

2. The law empowers the supervisor to set prudential rules administratively (without changing laws).

3. The law empowers the supervisor to require information from the banks in the form and frequency it deems necessary.

1 (4): A suitable legal framework for banking supervision is also necessary, including … powers to address compliance with laws as well as safety and soundness concerns.

Note: This component of Principle 1 is amplified in Principle 22 which addresses *Formal Powers of Supervisors*.

Essential criteria

1. The law enables the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision.

2. The law permits the supervisor to apply qualitative judgement in forming this opinion.

3. The supervisor has unfettered access to banks' files in order to review compliance with internal rules and limits as well as external laws and regulations.

4. When, in a supervisor's judgement, a bank is not complying with laws and regulations, or it is or is likely to be engaged in unsafe or unsound practices, the law empowers the supervisor to:

    - take (and/or require a bank to take) prompt remedial action;
    - impose a range of sanctions (including the revocation of the banking licence).

1 (5): A suitable legal framework for banking supervision is also necessary, including ... legal protection for supervisors.

Essential criteria

1. The law provides legal protection to the supervisory agency and its staff against lawsuits for actions taken while discharging their duties in good faith.

2. The supervisory agency and its staff are adequately protected against the costs of defending their actions while discharging their duties.

1 (6): Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.

Essential criteria

1. There is a system of cooperation and information sharing between all domestic agencies with responsibility for the soundness of the financial system.

2. There is a system of cooperation and information sharing with foreign agencies that have supervisory responsibilities for banking operations of material interest to the domestic supervisor.

3. The supervisor:

   - may provide confidential information to another financial sector supervisor;
   - is required to take reasonable steps to ensure that any confidential information released to another supervisor will be treated as confidential by the receiving party;
   - is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes.

4. The supervisor is able to deny any demand (other than a court order or mandate from a legislative body) for confidential information in its possession.

Principle 2: The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.

Essential criteria

1. The term “bank” is clearly defined in law or regulations.

2. The permissible activities of institutions that are licensed and subject to supervision as banks are clearly defined either by supervisors, or in laws or regulations.

3. The use of the word “bank” and any derivations such as “banking” in a name are limited to licensed and supervised institutions in all circumstances where the general public otherwise might be misled.

4. The taking of proper bank deposits[2] from the public is reserved for institutions that are licensed and subject to supervision.

[2] An example of a “proper” bank deposit is one that is not subject to security law disclosure requirements.

Principle 3: The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organisation's ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organisation is a foreign bank, the prior consent of its home country supervisor should be obtained.

Essential criteria

1. The licensing authority has the right to set criteria for licensing banks. These may be based on criteria set in law or regulation.

2. The criteria for issuing licences are consistent with those applied in ongoing supervision.

3. The licensing authority has the right to reject applications if the criteria are not fulfilled or if the information provided is inadequate.

4. The licensing authority determines that the proposed legal and managerial structures of the bank will not hinder effective supervision.

5. The licensing authority determines the suitability of major shareholders, transparency of ownership structure and source of initial capital.

6. A minimum initial capital amount is stipulated for all banks.

7. The licensing authority evaluates proposed directors and senior management as to expertise and integrity (fit and proper test). The fit and proper criteria include: (1) skills and experience in relevant financial operations commensurate with the intended activities of the bank and (2) no record of criminal activities or adverse regulatory judgements that make a person unfit to uphold important positions in a bank.

8. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance will be in place.

9. The operational structure is required to include, *inter alia*, adequate operational policies and procedures, internal control procedures and appropriate oversight of the bank's various activities. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.

10. The licensing authority reviews pro forma financial statements and projections for the proposed bank. This includes an assessment of the adequacy of the financial strength to support the proposed strategic plan as well as financial information on the principal shareholders of the bank.

11. If the licensing authority and the supervisory authority are not the same, the supervisor has the legal right to have its views considered on each specific application.

12. In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of “no objection”) of the home country supervisor is obtained.

13. If the licensing, or supervisory, authority determines that the licence was knowingly based on false information, the licence can be revoked.

Additional criteria

1. The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed.

2. At least one of the directors must have a sound knowledge of each of the types of financial activities the bank intends to pursue.

3. The licensing authority has procedures in place to monitor the progress of new entrants in meeting their business and strategic goals, and to determine that supervisory requirements outlined in the licence approval are being met.

Principle 4: Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.

Essential criteria

1. Law or regulation contains a clear definition of "significant" ownership.

2. There are requirements to obtain supervisory approval[3] or provide immediate notification of proposed changes that would result in a change in ownership or the exercise of voting rights over a particular threshold or change in controlling interest.

3. The supervisor has the authority to reject any proposal for a change in significant ownership or controlling interest, or prevent the exercise of voting rights in respect of such investments, if they do not meet criteria comparable to those used for approving new banks.

Additional criteria

1. Supervisors obtain from banks, either through periodic reporting or on-site examinations, the names and holdings of all significant shareholders, including, if possible, the identities of beneficial owners of shares being held by custodians.

[3] Supervisory approval may consist of either explicit prior approval or non-objection to a prior notification.

Principle 5: Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.

Essential criteria

1. Laws or regulations clearly define what types and amounts (absolute and/or in relation to a bank's capital) of acquisitions and investments need supervisory approval[4].

2. Laws or regulations provide criteria by which to judge individual proposals.

3. Consistent with the licensing requirements, among the objective criteria that the supervisor uses is that any new acquisitions and investments do not expose the bank to undue risks or hinder effective supervision. The supervisor determines that the bank has, from the outset, adequate financial and organisational resources to handle the acquisition/investment.

4. Laws or regulations clearly define for which cases notification after the acquisition or investment is sufficient. Such cases should primarily refer to activities closely related to banking and the investment being small relative to the bank's capital.

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[4] See footnote 3.

Principle 6: Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.

Essential criteria

1. Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. At least for internationally active banks, the definition of capital, method of calculation and the ratio required are not lower than those established in the Basel Capital Accord.

2. The required capital ratio reflects the risk profile of individual banks, in particular credit risk and market risk. Both on-balance-sheet and off-balance-sheet risks are included.

3. Laws or regulations, or the supervisor, define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.

4. Capital adequacy ratios are calculated and applied on a consolidated bank basis.

5. Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.

6. Regular (at least semi-annually) reporting by banks to the supervisor is required on capital ratios and their components.

Additional criteria

1. For domestic, as well as internationally active banks, the definition of capital is broadly consistent with the Basel Capital Accord.

2. The supervisor clearly sets out the actions to be taken if capital falls below the minimum standards.

3. The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile.

4. Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, minimum requirements may be higher than the Basel Accord.

5. Capital adequacy ratios are calculated on both a consolidated and a solo basis for the banking entities within a banking group.

6. Laws or regulations stipulate a minimum absolute amount of capital for banks.

(Reference document: "*International convergence of capital measurement and capital standards*" - July 1988)

Principle 7: An essential part of any supervisory system is the independent evaluation of a bank's policies, practices and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.

Essential criteria

1. The supervisor requires, and periodically verifies, that prudent credit-granting and investment criteria, policies, practices, and procedures are approved, implemented, and periodically reviewed by bank management and boards of directors[5].

2. The supervisor requires, and periodically verifies, that such policies, practices and procedures include the establishment of an appropriate and properly controlled credit risk environment, including:

   - a sound and well-documented credit granting and investment process;
   - the maintenance of an appropriate credit administration, measurement and ongoing monitoring/reporting process (including asset grading/classification); and
   - ensuring adequate controls over credit risk.

3. The supervisor requires, and periodically verifies, that banks make credit decisions free of conflicting interests, on an arm's-length basis, and free from inappropriate pressure from outside parties.

4. The supervisor requires that a bank's credit assessment and granting standards are communicated to, at a minimum, all personnel involved in credit granting activities.

5. The supervisor has full access to information in the credit and investment portfolios and to the lending officers of the bank.

Additional criteria

1. The supervisor requires that the credit policy prescribes that major credits or investments, exceeding a certain amount or percentage of the bank's capital, are to be decided at a high managerial level of the bank. The same applies to credits or investments that are especially risky or otherwise not in line with the mainstream of the bank's activities.

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5 This paper refers to a management structure composed of a board of directors and senior management. The Committee is aware that there are significant differences in legislative and regulatory frameworks across countries as regards the functions of the board of directors and senior management. In some countries, the board has the main, if not exclusive, function of supervising the executive body (senior management, general management) so as to ensure that the latter fulfils its tasks. For this reason, in some cases, it is known as a supervisory board. This means that the board has no executive functions. In other countries, by contrast, the board has a broader competence in that it lays down the general framework for the management of the bank. Owing to these differences, the notions of the board of directors and senior management are used in this paper not to identify legal constructs but rather to label two decision-making functions within a bank.

2. The supervisor requires that banks have management information systems that provide essential details on the condition of the loan and investment portfolios.

3. The supervisor verifies that bank management monitors the total indebtedness of entities to which they extend credit.

(Reference document: "*Principles for the Management of Credit Risk*" – July 1999.)

Principle 8: Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and reserves.

Essential criteria

1. Either laws or regulations, or the supervisor, sets rules for the periodic review by banks of their individual credits, asset classification and provisioning, or the law/regulations establish a general framework and require banks to formulate specific policies for dealing with problem credits.

2. The classification and provisioning policies of a bank and their implementation are regularly reviewed by the supervisor or external auditors.

3. The system for classification and provisioning includes off-balance-sheet exposures.

4. The supervisor determines that banks have appropriate policies and procedures to ensure that loan loss provisions and write-offs reflect realistic repayment expectations.

5. The supervisor determines that banks have appropriate procedures and organisational resources for the ongoing oversight of problem credits and for collecting past due loans.

6. The supervisor has the authority to require a bank to strengthen its lending practices, credit-granting standards, level of provisions and reserves, and overall financial strength if it deems the level of problem assets to be of concern.

7. The supervisor is informed on a periodic basis, and in relevant detail, concerning the classification of credits and assets and of provisioning.

8. The supervisor requires banks to have mechanisms in place for continually assessing the strength of guarantees and appraising the worth of collateral.

9. Loans are required to be identified as impaired when there is reason to believe that all amounts due (both principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.

10. The valuation of collateral is required to reflect the net realisable value.

Additional criteria

1. Loans are required to be classified when payments are contractually a minimum number of days in arrears (e.g., 30, 60, 90 days). Refinancing of loans that would otherwise fall into arrears does not lead to improved classifications for such loans.

2. The supervisor requires that valuation, classification and provisioning for large credits are conducted on an individual item basis.

(Reference document: "*Sound Practices for Loan Accounting and Disclosure*" – July 1999.)

Principle 9: Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.

Essential criteria

1. A "closely related group" is explicitly defined to reflect actual risk exposure[6]. The supervisor has discretion, which may be prescribed by law, in interpreting this definition on a case-by-case basis.

2. Laws or regulations, or the supervisor, set prudent limits on large exposures to a single borrower or closely related group of borrowers. "Exposures" include all claims and transactions, on-balance sheet as well as off-balance sheet.

3. The supervisor verifies that banks have management information systems that enable management to identify on a timely basis concentrations (including large individual exposures) within the portfolio on a solo and consolidated basis.

4. The supervisor verifies that bank management monitors these limits and that they are not exceeded on a solo and consolidated basis.

5. The supervisor regularly obtains information that enables concentrations within a bank's credit portfolio, including sectoral and geographic exposures, to be reviewed.

Additional criteria

1. Banks are required to adhere to the following definitions:

    - 10 percent or more of a bank's capital is defined as a large exposure;
    - 25 percent of a bank's capital is the limit for an individual large exposure to a private sector non-bank borrower or a closely related group of borrowers.

    Minor deviations from these limits may be acceptable, especially if explicitly temporary or related to very small or specialised banks.

(Reference document: "*Measuring and controlling large credit exposures*" – January 1991.)

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6 The definition can include not only legally related companies but also financially related companies, e.g., with common ownership. Also physical persons are considered as being parts of "closely related groups", e.g. when they have large economic interests at stake in the groups (for instance, when they are large shareholders).

Principle 10: In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.

Essential criteria

1. A comprehensive definition of "connected or related parties" exists in law and/or regulation. The supervisor has discretion, which may be prescribed in law, to make judgements about the existence of connections between the bank and other parties.

2. Laws and regulations exist that exposures to connected or related parties may not be extended on more favourable terms (i.e., for credit assessment, tenor, interest rates, amortisation schedules, requirement for collateral) than corresponding loans to non-related counterparties[7].

3. The supervisor requires that transactions with connected or related parties exceeding specified amounts or otherwise posing special risks are subject to approval by the bank's board of directors.

4. The supervisor requires that banks have procedures in place to prevent persons benefiting from the loan being part of the preparation of the loan assessment or of the decision itself.

5. Laws or regulations set, or the supervisor has the mandate to set on a general or case-by-case basis, limits for loans to connected and related parties, to deduct such lending from capital when assessing capital adequacy or to require collateralisation of such loans.

6. The supervisor requires banks to have information systems to identify individual loans to connected and related parties as well as the total amount of such loans, and to monitor them through an independent credit administration process.

7. The supervisor obtains and reviews information on aggregate lending to connected and related parties.

Additional criteria

1. The definition of "connected or related parties" established in law and/or regulation is broad and, generally, includes affiliated companies, significant shareholders, board members, senior management, key staff as well as close family members, corresponding persons in affiliated companies, and companies controlled by insiders and shareholders.

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[7] An exception may be appropriate for beneficial terms that are part of overall remuneration packages (e.g., employees receive credit at favourable rates.)

2. There are limits on aggregate exposures to connected and related parties that are at least as strict as those for single borrowers, groups or related borrowers.

Principle 11: Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.

Essential criteria

1. The supervisor determines that a bank's policies and procedures give due regard to the identification, monitoring and control of country risk and transfer risk. Exposures are identified and monitored on an individual country basis (in addition to the end-borrower/end-counterparty basis). Banks are required to monitor and evaluate developments in country risk and in transfer risk and apply appropriate countermeasures.

2. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies.

3. There is supervisory oversight of the setting of appropriate provisions against country risk and transfer risk. There are different international practices which are all acceptable as long as they lead to reasonable, risk-related, results. These include, *inter alia*:

   - The supervisor (or some other official authority) decides on appropriate minimum provisioning by setting fixed percentages for exposures to each country.
   - The supervisor (or some other official authority) sets percentage intervals for each country and the banks may decide, within these intervals, which provisioning to apply for the individual exposures.
   - The bank itself (or some other body such as the national bankers' association) sets percentages or guidelines or even decides for each individual loan on the appropriate provisioning. The provisioning will then be judged by the external auditor and/or by the supervisor.

4. The supervisor obtains and reviews sufficient information on a timely basis on the country risk/transfer risk of individual banks.

(Reference document: "*Management of banks' international lending*" – March 1982.)

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor and adequately control market risks; supervisors should have powers to impose specific limits and /or a specific capital charge on market risk exposures, if warranted.

Essential criteria

1. The supervisor determines that a bank has suitable policies and procedures related to the identification, measuring, monitoring and control of market risk.

2. The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign exchange business.

3. The supervisor has the power to impose a specific capital charge and/or specific limits on market risk exposures, including their foreign exchange business.

4. The supervisor verifies that banks have information systems, risk management systems and internal control systems to comply with those policies, and verifies that any limits (either internal or imposed by the supervisor) are adhered to.

5. The supervisor satisfies itself that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' positions are revalued frequently, using reliable and prudent market data.

6. The supervisor determines that banks perform scenario analysis, stress testing and contingency planning, as appropriate, and periodic validation or testing of the systems used to measure market risk.

7. The supervisor has the expertise needed to monitor the actual level of complexity in the market activities of banks.

Additional criteria

1. Either through on-site work, or through internal or independent external experts, the supervisor determines that senior management understands the market risks inherent in the business lines/products traded and that it regularly reviews and understands the implications (and limitations) of the risk management information that they receive.

2. The supervisor reviews the quality of management information and forms an opinion on whether the management information is sufficient to reflect properly the banks' position and exposure to market risk. In particular, the supervisor reviews the assumptions management has used in their stress testing scenarios, and the banks' contingency plans for dealing with such conditions.

3. The supervisor who does not have access to the adequate skills and capacity does not allow banks to determine their regulatory capital requirements based on sophisticated models, such as VaR.

(Reference document: "*Amendment to the Capital Accord to incorporate market risks*" - January 1996.)

Principle 13: Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor and control all other material risks and, where appropriate, to hold capital against these risks.

Essential criteria

1. The supervisor requires individual banks to have in place comprehensive risk management processes to identify, measure, monitor and control material risks. These processes are adequate for the size and nature of the activities of the bank and are periodically adjusted in light of the changing risk profile of the bank and external market developments. These processes include appropriate board and senior management oversight.

2. The supervisor determines that the risk management processes address liquidity risk, interest rate risk, and operational risk as well as all other risks, including those risks covered in other Principles (e.g., credit and market risk). These would include:

   - Liquidity: good management information systems, central liquidity control, analysis of net funding requirements under alternative scenarios, diversification of funding sources, stress testing and contingency planning. Liquidity management should separately address domestic and foreign currencies.
   - Interest rate risk: good management information systems and stress testing.
   - Operational risk: internal audit, procedures to counter fraud, sound business resumption plans, procedures covering major system modifications and preparation for significant changes in the business environment.

3. The supervisor issues standards related to such topics as liquidity risk, interest rate risk, foreign exchange risk and operational risk.

4. The supervisor sets liquidity guidelines for banks, which include allowing only truly liquid assets to be treated as such, and takes into consideration undrawn commitments and other off-balance- sheet liabilities, as well as existing on-balance-sheet liabilities.

5. The supervisor determines that limits and procedures are communicated to the appropriate personnel and primary responsibility for adhering to limits and procedures is placed with the relevant business units.

6. The supervisor periodically verifies that these risk management processes, capital requirements, liquidity guidelines and qualitative standards are being adhered to in practice.

Additional criteria

1. The supervisor has the authority to require a bank to hold capital against risks in addition to credit and market risk.

2. The supervisor encourages banks to include a statement on their risk management policies and procedures in their publicly available accounts.

3. Supervisors obtain sufficient information to enable them to identify those institutions carrying out significant foreign currency liquidity transformation.

4. The supervisor determines that, where a bank conducts its business in multiple currencies, management understands and addresses the particular issues this involves. Foreign currency liquidity strategy is separately stress-tested and the results of such tests are a factor in determining the appropriateness of mismatches.

(Reference documents: "*Principles for the management of interest rate risk*" – September 1997 and "*A framework for measuring and managing liquidity*" – September 1992.)

Principle 14: Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Essential criteria

1. Corporate or banking laws identify the responsibilities of the board of directors with respect to corporate governance principles to ensure that there is effective control over every aspect of risk management.

2. The supervisor determines that banks have in place internal controls that are adequate for the nature and scale of their business. These controls are the responsibility of the board of directors and deal with organisational structure, accounting procedures, checks and balances and the safeguarding of assets and investments. More specifically, these address:

   - Organisational structure: definitions of duties and responsibilities including clear delegation of authority (for example, clear loan approval limits), decision-making procedures, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance).
   - Accounting procedures: reconciliation of accounts, control lists, information for management.
   - Checks and balances (or "four eyes principles"): segregation of duties, cross-checking, dual control of assets, double signatures.
   - Safeguarding assets and investments: including physical control.

3. To achieve a strong control environment, the supervisor requires that the board of directors and senior management of a bank understand the underlying risks in their business and are both committed to, and legally responsible for, the control environment. Consequently, the supervisor evaluates the composition of the board of directors and senior management to determine that they have the necessary skills for the size and nature of the activities of the bank and can address the changing risk profile of the bank and external market developments. The supervisor has the legal authority to require changes in the composition of the board and management in order to satisfy these criteria.

4. The supervisor determines that there is an appropriate balance in the skills and resources of the back office and control functions relative to the front office/business origination.

5. The supervisor determines that banks have an appropriate audit function charged with (a) ensuring that policies and procedures are complied with and (b) reviewing whether the existing policies, practises and controls remain sufficient and appropriate for the bank's business. The supervisor determines that the audit function:

   - has unfettered access to all the bank's business lines and support departments;

- has appropriate independence, including reporting lines to the board of directors and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
- has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;
- employs a methodology that identifies the key risks run by the bank and allocates its resources accordingly.

6. The supervisor has access to the reports of the audit function.

Additional criteria

1. In those countries with a unicameral board structure (as opposed to a bicameral structure with a supervisory board and a management board), the supervisor requires the board of directors to include a number of experienced non-executive directors.

2. The supervisor requires the internal audit function to report to an Audit Committee.

3. In those countries with a unicameral board structure, the supervisor requires the Audit Committee to include experienced non-executive directors.

(Reference document: "*Framework for internal control systems in banking organisations*" – September 1998.)

Principle 15: Banking supervisors must determine that banks have adequate policies, practices and procedures in place, including strict "know-your-customer" rules, that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.

Essential criteria

1. The supervisor determines that banks have in place adequate policies, practices and procedures that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, by criminal elements. This includes the prevention and detection of criminal activity or fraud, and reporting of such suspected activities to the appropriate authorities.

2. The supervisor determines that banks have documented and enforced policies for identification of customers and those acting on their behalf as part of their anti-money-laundering program. There are clear rules on what records must be kept on customer identification and individual transactions and the retention period.

3. The supervisor determines that banks have formal procedures to recognise potentially suspicious transactions. These might include additional authorisation for large cash (or similar) deposits or withdrawals and special procedures for unusual transactions.

4. The supervisor determines that banks appoint a senior officer with explicit responsibility for ensuring that the bank's policies and procedures are, at a minimum, in accordance with local statutory and regulatory anti-money laundering requirements.

5. The supervisor determines that banks have clear procedures, communicated to all personnel, for staff to report suspicious transactions to the dedicated senior officer responsible for anti-money laundering compliance.

6. The supervisor determines that banks have established lines of communication both to management and to an internal security (guardian) function for reporting problems.

7. In addition to reporting to the appropriate criminal authorities, banks report to the supervisor suspicious activities and incidents of fraud material to the safety, soundness or reputation of the bank.

8. Laws, regulations and/or banks' policies ensure that a member of staff who reports suspicious transactions in good faith to the dedicated senior officer, internal security function, or directly to the relevant authority cannot be held liable.

9. The supervisor periodically checks that banks' money laundering controls and their systems for preventing, identifying and reporting fraud are sufficient. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its anti-money laundering obligations.

10. The supervisor is able, directly or indirectly, to share with domestic and foreign financial sector supervisory authorities information related to suspected or actual criminal activities.

11. The supervisor determines that banks have a policy statement on ethics and professional behaviour that is clearly communicated to all staff.

Additional criteria

1. The laws and/or regulations embody international sound practices, such as compliance with the relevant forty Financial Action Task Force Recommendations issued in 1990 (revised 1996).

2. The supervisor determines that bank staff is adequately trained on money laundering detection and prevention.

3. The supervisor has the legal obligation to inform the relevant criminal authorities of any suspicious transactions.

4. The supervisor is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.

5. If not performed by another agency, the supervisor has in-house resources with specialist expertise on financial fraud and anti-money laundering obligations.

(Reference document: "*Prevention of criminal use of the banking system for the purpose of money-laundering*" – December 1988.)

Principle 16: An effective banking supervisory system should consist of some form of both on-site and off-site supervision.

(Note: this Principle should be considered in conjunction with Principles 17 through 20.)

Essential criteria

1. Banking supervision requires an in-depth understanding, periodic analysis and evaluation of individual banks, focussing on safety and soundness, based on meetings with management and a combination of both on-site and off-site supervision. The supervisor has a framework that (1) uses on-site work (conducted either by own staff or through the work of external auditors) as a primary tool to:

   - provide independent verification that adequate corporate governance (including risk management and internal control systems) exists at individual banks;
   - determine that information provided by banks is reliable;
   - obtain additional information needed to assess the condition of the bank.

2. And (2) uses off-site work as a primary tool to:

   - review and analyse the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;
   - monitor trends and developments for the banking sector as a whole.

3. The supervisor checks for compliance with prudential regulations and other legal requirements through on-site and off-site work.

4. The appropriate mix of on-site and off-site supervision is determined by the particular conditions and circumstances of the country. In any event, the framework integrates the two functions so as to maximise the synergy and avoid supervisory gaps.

Additional criteria

1. The supervisor has procedures in place to assess the effectiveness of on-site and off-site functions, and to address any weaknesses that are identified.

2. The supervisor has the right to access copies of reports submitted to the board by both internal and external auditors.

3. The supervisor has a methodology for determining and assessing the nature, importance and scope of the risks to which individual banks are exposed, including the business focus, the risk profile and the internal control environment. Off-site and on-site work is prioritised based on the results of that assessment.

4. The supervisor is legally required to treat as confidential information received as part of the supervisory process. However, the supervisor is given powers under the law to disclose information in certain defined circumstances. The law prevents disclosure of

confidential information unless the supervisor is satisfied that it will be held confidential by the recipient, or unless disclosure is otherwise required by law.

5. The supervisor is able to reasonably place reliance on internal audit work that has been competently and independently performed.

Principle 17: Banking supervisors must have regular contact with bank management and a thorough understanding of the institution's operations.

Essential criteria

1. Based on the risk profile of individual banks, the supervisor has a programme of regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) to discuss operational matters such as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality, risk management systems etc.

2. The supervisor has a thorough understanding of the activities of its banks. This is accomplished through a combination of off-site surveillance, on-site reviews and regular meetings.

3. The supervisor requires banks to notify it of any substantive changes in their activities or any material adverse developments, including breach of legal and prudential requirements.

4. As part of the licensing process, and on an on-going basis during routine supervision, the supervisor considers the quality of management.

Principle 18: Banking supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on a solo and consolidated basis[8].

Essential criteria

1. The supervisor has the legal authority to require banking organisations to submit information, on both a solo and consolidated basis, on their financial condition and performance, at regular intervals. These reports provide data on matters such as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, loan loss provisioning, market risk and deposit sources.

2. Laws and regulations establish, or the supervisor has the authority to establish, the principles and norms regarding the consolidation of accounts as well as the accounting techniques to be used.

3. The supervisor has a means of enforcing compliance with the requirements that the information be submitted on a timely and accurate basis. The supervisor determines that the appropriate level of senior management is responsible for the accuracy of supervisory returns, can impose penalties for deliberate mis-reporting and persistent errors, and can require that inaccurate information be amended.

4. The information that is required to be submitted includes standardised prudential and statistical reports, and detailed balance sheets and income statements, as well as supporting schedules that provide details concerning on and off balance sheet activities and on reserves included in capital. Inclusion of data on loan classification and provisioning is also required.

5. The supervisor has the authority to request and receive any relevant information from banks, as well as any of their related companies, irrespective of their activities, where the supervisor believes that it is material to the financial situation of the bank or the assessment of the risks of the bank.

6. The supervisor has an analytical framework that uses the statistical and prudential information for the ongoing monitoring of the condition and performance of individual banks. The results are also used as a component of on-site supervision planning. This requires that the supervisor has an adequate information system.

7. In order to make meaningful comparisons between banking organisations, the supervisor collects data from all banks and all other relevant entities within a banking organisation on a comparable basis and related to the same dates (stock data) and periods (flow data).

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[8] This Core Principle refers to *accounting consolidation* which should be applied by one means or another to the whole bank, i.e. not only to the figures of a bank's branches but also to those subsidiaries in which the bank has a significant controlling interest.

8. The supervisor collects data from banks at a frequency (e.g., monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.

Principle 19: Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.

Essential criteria

1. The supervisor has in place a coherent process for planning and executing on-site visits, using either in-house examiners, or making use of the work of external auditors, as appropriate. There are policies and procedures in place to ensure that examinations are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs. The supervisor holds meetings with banks and their auditors to discuss the results of work by the external auditors and to agree on the responsibilities for corrective work.

2. The supervisor has the authority to monitor the quality of work done by external auditors for supervisory purposes. The supervisor has the authority to directly appoint external auditors for conducting supervisory tasks or oppose the appointment of an external auditor that is deemed to have inappropriate expertise and/or independence.

3. The supervisor can also make use of external auditors to examine specific aspects of banks' operations, provided there is a well developed, professionally independent auditing and accounting profession with skills to undertake the work required. The respective roles and responsibilities for the supervisor and the auditors in these circumstances are clearly defined by the supervisor.

4. The supervisor has the legal right of full access to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the board, senior management and staff, when required.

5. The supervisor has a programme for the periodic examination of supervisory returns by examiners or through the work of external auditors. There is a requirement that certain key supervisory returns such as that for capital adequacy be examined at least annually by the auditors and a report submitted to the supervisor.

Additional criteria

1. The supervisor meets with management and the board of directors each year to discuss the results of the supervisory examination or the external audit. Such visits should allow for the supervisor to meet separately with the independent board members.

2. The supervisor meets periodically with external audit firms to discuss issues of common interest relating to bank operations.

(Reference document: "*The relationship between bank supervisors and external auditors*" – July 1989.)

Principle 20: An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis[9].

Essential criteria

1. The supervisor is aware of the overall structure of banking organisations (i.e., the bank and its subsidiaries) or groups and has an understanding of the activities of all material parts of these groups, including those that are supervised directly by other agencies.

2. The supervisor has a supervisory framework that evaluates the risks that non-banking activities conducted by a bank or banking group may pose to the bank or banking group.

3. The supervisor has the legal authority to review the overall activities of a bank, whether the activities are conducted directly (including those conducted at overseas offices), or indirectly, through subsidiaries and affiliates of the bank.

4. There are no impediments to the direct or indirect supervision of all affiliates and subsidiaries of a banking organisation.

5. Laws or regulations establish, or the supervisor has the authority to impose, prudential standards on a consolidated basis for the banking organisation. The supervisor uses its authority to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits.

6. The supervisor collects consolidated financial information for each banking organisation.

7. The supervisor has arrangements with functional regulators of individual business vehicles within the banking organisation group, if material, to receive information on the financial condition and adequacy of risk management and controls of such business vehicles.

8. The supervisor has the authority to limit or circumscribe the range of activities the consolidated banking group may conduct and the overseas locations in which activities can be conducted; the supervisor uses this authority to determine that the activities are properly supervised and that the safety and soundness of the banking organisation is not compromised.

Additional criteria

1. For those countries that allow corporate ownership of banking companies:

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[9] 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.

- the supervisor has the authority to review the activities of parent companies and of companies affiliated with the parent companies, and utilises the authority in practice to determine the safety and soundness of the bank;
- the supervisor has the authority to take remedial actions, including ring-fencing, regarding parent companies and non-bank affiliates concerning matters that could impact the safety and soundness of the bank; and
- the supervisor has the authority to establish and enforce fit and proper standards for owners and senior management of parent companies.

(Reference documents: "*Consolidated supervision of banks' international activities*" – March 1979; "*The supervision of cross-border banking*" – October 1996.)

Principle 21: Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.

Essential criteria

1. The supervisor has the authority to hold management responsible for ensuring that financial record keeping systems and the data they produce are reliable, and that supervisor-required reports are submitted on a timely and accurate basis.

2. The supervisor has the authority to hold management responsible for ensuring that the management report and financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.

3. The supervisor ensures that information from bank records is verified periodically through on-site examinations and/or external audits.

4. The supervisor ensures that there are open communication lines with the external auditors.

5. The supervisor provides report instructions that clearly establish the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that command wide international acceptance and are aimed specifically at banking institutions.

6. The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and that profits are net of appropriate provisions.

7. Laws or regulations set, or the supervisor has the authority, in appropriate circumstances, to establish, the scope and standards to be achieved in external audits of individual banks, and to make public issuance of individual bank financial statements subject to its prior approval.

8. The supervisor has the ability to treat as confidential certain types of sensitive information.

9. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that command wide international acceptance and have been audited in accordance with internationally accepted auditing practices and standards.

10. The supervisor has the right to revoke the appointment of a bank's auditors.

11. Where supervisors rely primarily on the work of external auditors (rather than on their own examination staff), banks are required to appoint auditors who are recognised by the supervisor as having the necessary professional skills and independence to perform the work.

Additional criteria

1. The supervisor promotes periodic public disclosures of information that are timely, accurate, and sufficiently comprehensive to provide a basis for effective market discipline.

2. The supervisor has guidelines covering the scope and conduct of audit programmes that ensure that audits cover such areas as the loan portfolio, loan loss reserves, non-performing assets, asset valuations, trading and other securities activities, derivatives, asset securitisations, and the adequacy of internal controls over financial reporting.

3. Auditors have the legal duty to report to the supervisor matters of material significance, for example, failure to maintain the licensing criteria, or breaches of banking or other laws. The law protects auditors from breach of confidentiality when information is communicated in good faith.

4. Auditors also have the legal duty to report matters to the supervisor, in situations where they become aware of matters which, in the context of the available information, they believe is likely to be of material significance to the functions of the supervisor.

Principle 22: Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.

Essential criteria

1. The supervisor has the authority, backed by legal sanctions, to take an appropriate range of remedial actions against, and impose penalties upon, banks, depending on the severity of a situation. These remedial actions are used to address such problems as failure to meet prudential requirements and violations of regulations. They range from informal oral or written communication with bank management to actions that involve the revocation of the banking license.

2. The range of possible actions available is broad, including, in addition to the others mentioned, restricting the current activities of the bank, withholding approval of new activities or acquisitions, restricting or suspending payments to shareholders or share repurchases, restricting asset transfers, barring individuals from banking, replacing or restricting the powers of managers, directors, or controlling owners, arranging a take-over by or merger with a healthier institution, and imposing conservatorship.

3. The supervisor ensures that remedial actions are taken in a timely manner.

4. The supervisor applies penalties and sanctions not only to the bank, but, when and if necessary, also to management and/or the board of directors.

Additional criteria

1. Laws and/or regulations mitigate against the supervisor unduly delaying appropriate corrective actions.

2. The supervisor addresses all significant remedial actions in a written document to the board of directors and requires that progress reports are submitted in writing as well.

Principle 23: Banking supervisors must practise global consolidated supervision over their internationally active banking organisations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organisations worldwide, primarily at their foreign branches, joint ventures and subsidiaries.

Essential criteria

1. The supervisor has the authority to supervise the overseas activities of locally incorporated banks.

2. The supervisor satisfies itself that management is maintaining proper oversight of the bank's foreign branches, joint ventures, and subsidiaries. It also satisfies itself that the local management of any overseas offices has the necessary expertise to manage those operations in a safe and sound manner.

3. The supervisor determines that bank management's oversight includes: a) information reporting on its overseas operations that is adequate in scope and frequency and is periodically verified; b) assessing in an appropriate manner compliance with internal controls; and c) ensuring effective local oversight of foreign operations.

4. The home country supervisor has the authority to require closing of overseas offices, or imposing limitations on their activities, if it determines that the supervision of a local operation by the bank and/or by the host country supervisor is not adequate relative to the risks the office presents.

Additional criteria

1. The supervisor has a policy for assessing whether it needs to conduct on-site examinations or require additional reporting, and it has the legal authority and resources to take those steps as and when appropriate.

2. The supervisor ensures that management's local oversight of foreign operations is particularly close when the foreign activities have a higher risk profile and/or when they differ fundamentally from those conducted in the home country, or are conducted at locations that are especially remote from the principal locations at which the bank conducts comparable activities.

3. The supervisor arranges to visit the offshore locations periodically, the frequency determined by the size and risk profile of the overseas operation. The supervisor meets the local supervisors during these visits.

4. The home country supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.

(Reference documents: "*Principles for the supervision of banks' foreign establishments*" – May 1983; "*Minimum standards for the supervision of international banking groups and their cross-border establishments*" – July 1992; "*The supervision of cross-border banking*" – October 1996.)

Principle 24: A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.

Essential criteria

1. For significant overseas operations of its banks, the home country supervisor establishes informal or formal arrangements (such as memoranda of understanding) with host country supervisors for appropriate information-sharing on the financial condition and performance of such operations in the host country. Information sharing arrangements with host country supervisors include being advised of adverse assessments of such qualitative aspects of a bank's operations as the quality of risk management and controls at the offices in the host country.

2. The supervisor can prohibit banks or their affiliates from establishing operations in countries with secrecy laws or other regulations prohibiting flows of information deemed necessary for adequate supervision.

3. The home supervisor provides information to host country supervisors concerning the specific offices in the host country, concerning the overall framework of supervision in which the banking group operates, and, to the extent appropriate, concerning significant problems arising in the head office or in the group as a whole.

Additional criteria

1. A supervisor who takes consequential action on the basis of information received from another supervisor, consults with that supervisor, to the extent possible, beforehand.

2. Even for less than significant overseas operations of its banks, the home country supervisor exchanges appropriate information with host country supervisors.

(Reference documents: same as for Principle 23.)

Principle 25: Banking supervisors must require the local operations of foreign banks to be conducted to the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.

Essential criteria

1. Local branches and subsidiaries of foreign banks are subject to similar prudential, inspection, and regulatory reporting requirements as domestic banks.

2. For purposes of the licensing process as well as ongoing supervision, the host country supervisor assesses whether the home country supervisor practices consolidated global supervision.

3. The host supervisor, before issuing a licence, determines that approval (or no objection) from the home supervisor has been received.

4. The host country supervisor can share with home country supervisors information about the local operations of foreign banks provided its confidentiality is protected.

5. Home country supervisors are given on-site access to local offices and subsidiaries for safety and soundness purposes.

6. The host country supervisor advises home country supervisors on a timely basis of any material remedial action it takes regarding the operations of a bank from that country.

Additional criteria

1. The host country supervisor obtains from home country supervisors sufficient information on the banking group to allow it to put into proper perspective the activities conducted within its borders.

(Reference documents: same as for Principle 23.)

Annex

STRUCTURE AND METHODOLOGY FOR ASSESSMENT REPORTS PREPARED BY THE INTERNATIONAL MONETARY FUND AND THE WORLD BANK[1]

Introduction

1. This annex presents a format for the organisation and methodology of the assessment reports that is recommended by the IMF and World Bank for use by their assessment teams. The report should be in four parts: (1) a brief executive summary; (2) a main body, which should cover the inputs which were used, the methodology and the findings; (3) an assessment of compliance with each Core Principle; and (4) the response of the supervisory agency to the assessment received. Since the broad findings are built up from the details, proposals regarding the Principle-by-Principle assessment will be discussed first, followed by the main body, supervisory response and the executive summary.

Principle-by-Principle Assessment

2. The Principle-by-Principle assessment should evaluate compliance with each Core Principle, and when appropriate, for each subsection of that Principle. As discussed in Chapter II, while compliance with Core Principles 2 through 25 can generally be addressed individually, a more detailed analysis of Principle 1 is required, given its importance for assessing the overall potential effectiveness of the banking supervision function.

3. The assessment should have an introductory section, which should generally be in two parts. The first should be a note explaining the abbreviations used, such as, the supervisory authority, the central bank, and any laws and regulations that are frequently referenced. The second part should be a paragraph stating what types of institutions (and what financial services they provide) are supervised by the supervisory authority, and any special aspects of the coverage of the assessment; for example, if the authority supervises credit unions but they are not included in the assessment because they are of little material importance to the financial system. In addition, the authors should also note whether the assessment will take into account additional criteria.

4. The assessment of each Core Principle should be presented under a heading stating the Principle number in bold and Principle text in italics.

5. Each assessment should be in two parts (Box 1 presents a sample assessment). The first part should present the descriptive information relevant to compliance with the given Core Principles and its supporting criteria (as laid out in Chapter III). The discussion should

[1] This annex was prepared by staff of the IMF and the World Bank and is provided here as an example of how an assessment could be conducted.

begin with quotes from the relevant supporting laws, regulations, guidelines, reports, etc., and then review other relevant descriptive information, such as staffing levels, supervisory tools, and the like.

SAMPLE ASSESSMENT

Principle 6: *Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord***.**

Description: Article 9 of the Law on Banks (LoB) states that the risk-weighted capital ratio shall not fall below 8 percent. Article 10 of the LoB states the rules for calculating own funds and subordinated capital and defines eligible capital. The rules on capital apply to all banks that are licensed in the country on a solo (bank) basis but not on a consolidated (bank group) basis. There are no capital requirements for market risks. Banks must report their capital adequacy ratios and their components to the supervisory authority quarterly. If the capital adequacy ratio falls below 8 percent, the law empowers the supervisory authority to start a so-called “intensified supervisory procedure”. In this procedure, the supervisor may take a number of measures to safeguard the bank and its counterparties, including revocation of the licence.

Assessment: With regard to CP 6, the country is materially non-compliant. Some parts of CP 6 fulfil more than the essential criteria, but other important parts are still lacking. The capital adequacy requirements for credit risk are in conformity with the Basel Capital Accord and they are applied to all banks, which is above the minimum standard. There is also a clear procedure for supervisory action when banks fall below the minimum capital ratio, and the assessor has determined that such procedures have actually been applied in several instances. Reporting of capital ratios is of adequate frequency and provides an appropriate amount of information. Despite the fact that most of the internationally-active banks incur substantial market risk, there are no capital requirements for such risk. There is an urgent need to prepare the necessary regulations, guidelines, and reporting forms for introducing capital requirements for market risks. In addition, the supervisors need to develop the necessary skills to supervise these activities. Finally, there is no capital adequacy requirement for the consolidated banking organisation. Considering the increasing number of banking group formations in the country, consolidated capital adequacy requirements should be introduced on a priority basis. (See also CP 18.)

Our overall judgement of “materially non-compliant” is based on the two main deficiencies in relation to the Basel Accord: lack of capital charges for market risk and no application of capital requirements on a consolidated bank basis. In order to be regarded as “compliant”, these deficiencies need to be promptly addressed, at least for the internationally-active banks.

6. The second part should present a qualitative assessment of the degree of compliance with the given Core Principle. It should begin with a summary assessment. The proposed summary assessment includes four categories based on the assessor's views on the extent of compliance with the objective of the Principle: compliant; largely compliant; materially non-compliant; or non-compliant (for further detail, see paragraph 16, below). To achieve full compliance with a Principle, all essential criteria generally must be met without any significant deficiencies. There may be instances where a country can demonstrate that the Principle has been achieved through different means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore one or more additional criteria and/or other measures may also be deemed necessary by the assessor to judge that compliance with a given Principle is achieved.

7. The general assessment should also contain a discussion of the reasons underlying the assessment. Insofar as possible, and as relevant, the discussion should be structured as follows: (1) banking laws and other laws; (2) prudential regulations, including prudential reports and public disclosures; (3) supervisory tools and instruments; (4) institutional capacity of the supervisory agency; and (5) evidence of enforcement or non-enforcement. Note: Items 3 and 4 may frequently be combined.

8. The assessment should also highlight when and why compliance with a particular criterion could not be adequately assessed, such as when certain information was not provided, or when key individuals were unavailable to discuss important issues. Such requests for information or meetings should be documented in writing so as to clearly demonstrate the assessors' attempts to adequately assess a criterion. In such cases, the assessors should generally treat such information gaps as evidence of non-compliance. Important interactions should also be taken into account, particularly when issues relating to one Core Principle could have a material impact on the assessment of compliance with another Principle (e.g., weaknesses in Principle 8, policies on loan loss provisioning, could influence the assessment of Principle 6 on capital adequacy).

9. In cases where shortcomings have been identified, explanatory comments will also generally be useful. The discussion should cover specific areas of non-compliance, and the importance of those shortcomings, as well as actions that are being taken or contemplated to address these issues, and the timetable within which these changes are envisaged.[2] However, the assessment should always be based on the current situation, and envisaged changes should not be used as a reason to alter the assessment of compliance. This section might also highlight the urgency of a particular reform.

Main Body

10. The main body should begin with an introductory paragraph which describes the organisation being assessed, and, if relevant, the context in which the assessment is being given/requested (e.g., as an input to developing a detailed program to achieve full compliance

2 In some cases, the assessor may wish to note that compliance is complete except for a specific exception which is being addressed. In such cases, the assessment might state "Principle x will be fully complied with when…" but even then, the discussion should note how important the exception is with respect to the assessment of overall compliance.

with the Core Principles). This paragraph should also list the lead organisation responsible for the assessment, the individuals involved in making the assessment and the organisations they represent, and their qualifications. It should also state that the report is in two parts, the main body, which presents the conclusions and recommendations, and the Principle-by-Principle assessment.

11. The second paragraph should summarise the main information used in formulating the assessment. This would be likely to include any self-assessments, the relevant laws, regulations and instructions, and discussions with the supervisory authority, other domestic supervisory authorities, any relevant government ministries, as well as domestic bankers, the bankers' association, auditors, and other financial sector participants. The paragraph should also highlight what, if any, information was not provided, and why, as well as any issues or problems which may have had an impact on the accuracy of the assessment (e.g., uncooperative domestic supervisors or bankers).

12. The next section should present the conclusions and recommendations. It will generally begin with a discussion of issues related to the preconditions for effective banking supervision, presented in a sub-section entitled "Preconditions for Effective Banking Supervision".[3] This discussion should focus on any weaknesses and shortcomings in these preconditions, and to the extent possible, explore the potential implications of those problems for the fulfilment of the Core Principles. The discussion might follow the structure of this discussion in the Core Principles document: (1) macroeconomic issues; (2) infrastructure; (3) market discipline; (4) resolution of problems in banks; and (5) public safety net. Issues arising from problems in the preconditions may also be raised in the discussion of compliance with particular principles.

13. The next sub-section will be presented under the heading "Core Principles". It should include four paragraphs. The first two paragraphs should summarise the methodology used, and should be structured along the following lines:

"The assessment of fulfilment of the Core Principles is not, and is not intended to be an exact science. Banking systems differ from one country to the next, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, it is internationally acknowledged that the Core Principles are seen as minimum standards.

"The assessment of compliance with each Principle is made on a qualitative basis.[4] A five-part assessment system is used: compliant; largely compliant; materially non-compliant; non-compliant; and not applicable. To achieve a "compliant" assessment with a Principle, all essential criteria generally must be met without any significant deficiencies. There may be instances where a country can demonstrate that the Principle has been achieved through different means. Conversely, due to the specific conditions in individual countries, the essential criteria may not always be sufficient to achieve the objective of the Principle, and therefore one or more additional criteria and/or other measures may also be deemed necessary

3 See Chapter 1 Par. 27 to 32.

4 A qualitative assessment was necessary because a major shortcoming with respect to any important criteria may be sufficient to raise serious doubts about the degree of compliance.

by the assessor to judge that compliance is achieved. A “largely compliant” assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority’s ability to achieve the objective of that Principle. A “materially non-compliant assessment” is given when the shortcoming are sufficient to raise doubts about the authority’s ability to achieve compliance, but substantive progress had been made. A “non-compliant” assessment is given when no substantive progress towards compliance has been achieved (e.g., for Principle 20 if banks do not report on a consolidated basis, or when insufficient information was available to allow a reliable determination that substantive progress had been made towards compliance).

14. The third paragraph in this section is pivotal. It should begin by noting that while laws and regulations are important aspects of effective supervision, they will be of limited value unless the supervisory function also has an adequate degree of independence, capacity, competence, integrity; in effect, Core Principle 1 must be largely complied with. Furthermore, the authorities must also be willing to carry out their mandate. The remainder of this paragraph should focus on whether these preconditions are, in fact, being met.

15. The fourth paragraph should summarise the overall assessment of compliance with the Core Principles. The first sentence should note how many Principles fall into each assessment category. It should also note any efforts that are underway to achieve compliance, and what the overall situation will be regarding compliance when the current efforts are concluded, as well as when those efforts are scheduled to conclude. However, an assessment of the overall state of compliance should not be given.

16. A summary of the assessment should then be presented. It should be in seven sections, grouped by degree of compliance, and by whether efforts to achieve full compliance are currently underway.[5] This requires grouping the Core Principles into one of the following categories:

- Non-compliant, and efforts to achieve compliance not underway
- Non-compliant, and efforts to achieve compliance underway
- Materially non-compliant, and efforts to achieve compliance not underway
- Materially non-compliant, and efforts to achieve compliance underway
- Largely compliant, and efforts to achieve full compliance not underway
- Largely compliant, and efforts to achieve full compliance underway
- Compliant

17. For each Core Principle falling under a particular heading, the assessor should insert a bullet point which includes: the number of the Principle; a parenthetic note summarising the Principles; a brief summary of the shortcomings; and, if applicable, a brief description of the steps being taken to remedy the problem. Should there be a clear case where none of the

5 If appropriate, groups can also be combined, for example if few changes are planned.

above categories applies to a particular Core Principle, this situation should be mentioned in the fourth paragraph. Also, in this instance, the relevant Core Principle need not be slotted into any of the categories. Key interactions between Principles should also be noted. An example of one such section is:

"**Largely compliant, and efforts to achieve full compliance underway:**

- **Principle 6** (capital requirements). As noted under Principle 12, capital charges for market risks should be introduced. This regulation is being drafted, and its full implementation is scheduled for August 1999.

- **Principle 9** (management information systems). The present project of evaluating banks' management information systems must be completed. The project has started and completion is scheduled for end-1999.

18. In the last paragraph of this section, the assessor should note the priorities for achieving full compliance with all Core Principles, including measures relating to the preconditions. The focus should be on areas where shortcomings have been identified, but actions are not being taken to achieve full compliance. Since the shortcomings should have already been discussed, the items need only be noted. Thus, the paragraph might be as follows:

"If the present plans for the preparation of new regulations, reporting forms, evaluations, etc. are followed, the following Core Principles remain to be addressed (in order of priority):

- **Principle 11** Requirement for country and transfer risks

- **Principle 5** Pre-notification of major new investments

In addition shortcomings with respects to the following pre-conditions need to be addressed (in order of priority):

- Law on collateral

- **Rules** governing certification of accountants."

Supervisory Response

19. While the assessors have sole responsibility for the outcome of any assessment, it is important that the supervisory agency or agencies being assessed have an opportunity to respond to the assessment findings. The assessment should be a genuine consultative process and therefore the assessment team should have had frequent discussions with the supervisors during the assessment so that the findings should reflect the comments and concerns of the supervisors. The agency or agencies should be requested to prepare a concise written response to the findings and this response should be incorporated into the assessment report. Any differences of opinion on the assessment results should be clearly identified. The full text of the response should be attached to the assessment report.

Executive Summary

20. Each assessment report should begin with a brief executive summary. The first paragraph should state that this is an assessment of compliance with the Core Principles; with whom the assessment team talked; the laws, regulations and other information that were used; and whether the team faced any problems in making its assessment, either as a result of problems in gathering data or other inputs, or from a lack of co-operation. There should be also a footnote stating which organisation sponsored or hired the assessment team.

21. The next paragraph should summarise the assessor's views regarding the overall capacity of the local supervisory system, and provide a general view of whether the supervisory authority is currently able and willing to carry out its mandate, and to achieve compliance with the Core Principles. It should also note what efforts are underway to fill any gaps in compliance. The discussion should be qualitative, and an overall assessment of compliance should not be provided.

22. The following paragraphs should review the Core Principles which are out of compliance, and highlight the main strengths of the supervisory system. To the extent possible, brief summaries for the reasons for non-compliance should be given, particularly for those Principles which are assessed as being "materially non-compliant" or "non-compliant". It may also be useful to group Principles by whether or not their shortcomings are being addressed.

23. The penultimate paragraph should summarise the current state of compliance with the Core Principles, as well as the degree of compliance that will be achieved if current efforts proceed as envisaged. In addition, it should list which Principles are expected to remain seriously out of compliance, based on the authority's current work program, and give the assessor's views on the order in which they should be addressed.

24. The final paragraph should summarise the response of the supervisory agency or agencies being assessed to the findings of the assessment.