Basel Committee
on Banking Supervision

Conducting a Supervisory Self-Assessment

Practical Application

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BANK FOR INTERNATIONAL SETTLEMENTS

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Introduction

1. The objective of the self-assessment is to produce a comprehensive, credible and action-oriented overview of the national banking supervisory system based on the *Basel Core Principles for Effective Banking Supervision* and the *Core Principles Methodology*. In conducting a self-assessment, supervisory authorities seek to benchmark their own supervisory system against the Core Principles, with the ultimate goal of enhancing the effectiveness of supervision. The process is not necessarily a one-time event and supervisory authorities may choose to conduct self-assessments on a periodic basis.

2. This paper presents a framework that banking supervisory authorities can use to conduct self-assessments of their supervisory systems. The framework is derived in large part from the insights gained from self-assessments that have been conducted by a number of countries since the publication by the Basel Committee of its *Core Principles* and *Core Principles Methodology*.

3. The *Core Principles* and *Core Principles Methodology* set a high standard of practice. Therefore, it is to be expected that any country conducting a rigorous and objective self-assessment will find some gaps and shortcomings in its banking supervisory system. In the final analysis, the assessors must form a judgement as to whether the supervisory authority has the capacity to supervise adequately the banking sector, and whether the supervisory methods used by the supervisory authority contribute effectively to that goal. If they do not, it is incumbent on the supervisory authority to take action. A programme of reform should also include any necessary measures that would have to be taken by other authorities (e.g., legislators, regulators).

4. The self-assessment framework is designed to be suitable for all types of jurisdictions, irrespective of the degree of development of the banking system or the nature of the supervisory system. The framework places particular emphasis on the practical aspects of self-assessment, highlighting specific questions that need to be asked and obstacles that may be encountered along the way. It employs a multi-phase approach, with a view to conducting the most comprehensive analysis possible. Finally, it suggests the use of a template in which the different steps of the assessment are summarised as set out in the annex of the *Core Principles Methodology* document.

5. The self-assessment is a time consuming and resource intensive process; however, the benefits are numerous. Among the most important of these is the added value that such an exercise will provide to an external assessment. It lays the groundwork for supervisory authorities to begin taking steps towards more effective supervision, rather than waiting for an external assessment to take place. It will lead to more productive discussions with the external assessors, as the detailed criteria will have already been reviewed internally. It can also assist the external assessors by providing background material for their work.

6. This document consists of three sections:

I the self-assessment strategy;

II the four phases of self-assessment (review of the legal framework, review of the practical application of supervisory policies and procedures, assessment of compliance with the Core Principles, and the drawing up of an action plan to address identified weaknesses);

III the self-assessment report.

I. The self-assessment strategy

7. It is essential to the success of the self-assessment exercise that the supervisory authority establish clearly from the outset the strategy in terms of the objectives of the exercise, the preconditions that will be applied, and the resources to be committed. Conditions necessary to ensure the credibility and objectivity of the self-assessment will include the explicit commitment of the supervisory authority's senior management, the creation of a qualified team of assessors, a comprehensive review, the participation/cooperation of all members of the organisation, and resistance to political pressure.

A. Objectivity

8. There can be a tendency to be tolerant of the shortcomings and country-specific aspects of one's own supervisory system, particularly those stemming from long-standing factors that are largely or entirely outside the supervisory authority's control. Such factors can include the structure of the country's financial, legal, and/or political systems. If the self-assessment exercise is to succeed in revealing the strengths and weaknesses of the supervisory system, it is imperative that those conducting the self-assessment are allowed to maintain objectivity and neutrality.

9. Having a thorough, independent review of the results of the self-assessment can reinforce the commitment to objectivity. External assistance may be obtained in order to conduct an assisted self-assessment. However, care should be taken that the supervisory authority retains responsibility for and ownership of the self-assessment and the use of external experts would only be considered as an additional resource. Several countries may consider pooling resources with the objective of conducting peer reviews of compliance against the Core Principles. This could provide an independent check on the objectivity and credibility of the assessment. In general, everything possible should be done to ensure the integrity and reliability of the findings.

10. Credibility could be enhanced by having the self-assessment include the terms of reference and credentials of the team, the time frame for the assessment, the review process, and how the comments and observations of the review team have been addressed. The report should certify that the self-assessment was conducted strictly on the basis of the Core Principles and the related Methodology, with appropriate references to these documents in the report.

B. Preconditions for a comprehensive and credible self-assessment

11. Due to the fact that political authorities may have a role to play in implementing necessary reforms, the supervisors may choose to inform these authorities (Parliament, Congress, Finance or Treasury Ministry) of the exercise, its objectives, and the timetable for completion. The political authorities would not normally be directly involved in the self-assessment process. Political interference in the conduct of the self-assessment (while it is underway) may undermine the credibility of the self-assessment. In particular, the supervisory authority may be pressured to render a more favourable assessment of national policies or practices. Alternatively, the organisation may modify its assessment in anticipation of pressure from political authorities, because it fears that an admission of supervisory shortcomings will be used as an argument for weakening its authority.

12. A key step in the process of self-assessment is determining the required resources. The institution needs to make the self-assessment an explicit priority for the organisation. In order to ensure the quality of the work and the credibility of the final product, the organisation will need to provide an adequate number of highly skilled staff.

13. The resource requirements for a self-assessment may put a strain on some smaller countries or supervisory authorities. Should it not be possible to obtain outside assistance to compensate for this limitation, the banking supervisory authority may first choose to assess the essential criteria in the *Methodology* document and conduct a review of the additional criteria at a later stage.

14. The self-assessment is typically conducted by individuals integrated into the normal staff activities of the supervisory authority. Ideally, these individuals will bring a variety of different competencies to the team, as reflected in their training and work experience. This will permit some specialisation of tasks. It is critical that the team is able to devote sufficient time and resources to the exercise. Sometimes these individuals work on the assessment together with external experts. Performing a self-assessment can place a strain on the resources of the supervisory authority and possibly draw some of the best-trained supervisors out of the day-to-day work of the agency; however, the long-term benefits of the self-assessment process justify the commitment of resources to this task.

15. The successful conduct of a self-assessment requires the cooperation of staff, and as a precondition to cooperation, a high degree of awareness of the project throughout the organisation. This requires the involvement, from the outset, of the most senior supervisory officials in setting objectives, overseeing the project on an ongoing basis, and setting priorities for the reforms that will be subsequently pursued. The involvement and support of senior management helps to obtain the cooperation of the various departments throughout the organisation. One of the primary responsibilities of the self-assessment team is to keep senior management regularly informed of the progress of the exercise with a formal two-way communication process between assessors and senior management.

16. As a general rule, a self-assessment will require the participation of staff from virtually every part of the organisation. It will require substantial input from on-site and off-site supervisory personnel, legal staff, policy development staff, enforcement, accounting, human resources, and so forth. It may be helpful, in managing the division of responsibilities, to draw up a formal partition of tasks identifying departments that will have primary responsibility for providing input to the drafting of the assessment of each criterion, as well as an interactive process for soliciting input from other departments that have something to contribute.

17. Those conducting the self-assessment must report directly to senior management. During the course of the self-assessment, senior management may need to intervene, for example, if the assessors were to face difficulties in receiving full support from staff or if a lack of resources would delay the completion of the assessment. Senior management needs to clarify that the self-assessment is being carried out for the overall benefit of the organisation. Staff involved in the self-assessment process should be given free rein and the same protection as that accorded internal auditors at banks.

II. The four phases of self-assessment

18. There are four phases to the self-assessment process:

Phase 1: A review of the legal framework that governs the supervisory process (laws, edicts, and regulations);

Phase 2: A review of the practical application of supervisory policies and procedures;

Phase 3: An assessment of the extent of compliance with the criteria set out in the *Core Principles Methodology*; and

Phase 4: The drawing up of an action plan to address identified weaknesses.

This four-step process should be applied to each criterion related to a Core Principle.

19. The results of phases 1-3 should be compiled in a table that can take the form illustrated in the Appendix. This matrix provides a "snapshot" of the extent of compliance against each criterion and will be used subsequently for identifying existing gaps and also for devising any necessary corrective actions.

Phase 1: Reviewing the legal framework

20. The assessment of the legal framework consists of identifying the laws, decrees, and regulations applicable to the individual criteria set out in the *Core Principles Methodology*. In many cases, a single legal text will address numerous criteria, often spanning several different Principles. The review of legal references should be as detailed as possible and provide a brief identification of their content, including necessary interpretations to enhance their understanding. It is essential that the review include the banking laws, as well as other laws affecting the banking sector. For example, this may include relevant sections of the administrative code (legal protection of the supervisors), and of commercial law (delegation of powers, separation of functions).

21. As illustrated in the Appendix, the assessment of the essential criteria of Core Principle 12 takes the form of a review of legal texts relating to market risk, with the dual objective of determining:

1. ***Completeness***: whether each aspect of the supervision of market risk mentioned in an essential or additional criterion is addressed in the legal framework, and
2. ***Content***: what, specifically, the legal texts require or provide for.

The results of phase 1 are entered in the second column of the table. The third column corresponds to phase 2, discussed below.

22. In this particular case, the legal requirements relating to market risk are contained in two regulations that:

- apply to banking establishments and investment firms (i.e., all relevant institutions are covered*)*;
- require these institutions to have systems for measuring and controlling market risk, while specifying conditions that must be satisfied (measurement on a consolidated basis, within specified limits, etc.);
- require supervisors to verify that those requirements are satisfied, and give supervisors the authority to enforce those requirements (authority to set specific capital requirements and limits on market exposures for specific institutions, to require remedial actions, etc.).

23. This phase of the exercise may identify several distinct types of shortcomings:

- the absence of any legal text addressing a particular criterion*.*
- the existence of a legal text, which, however, fails to cover all aspects of the criterion. For example, (using the example of essential criterion 12(1) in the preceding illustration), a legal text might require identification and measurement of market risks but not mention monitoring or control.
- the existence of a legal text that covers all aspects of the criterion but sets inappropriate or weak standards. For example, (again using the example of essential criterion 12(1)), a legal text might require banks to monitor their market risks, but specify a frequency for monitoring (monthly rather than daily) that is inadequate, in view of the nature of the risks.

24. The task of the assessor is to characterise the nature of the discrepancy between what is called for in the Core Principles criteria and what is actually provided for in the law. This will provide the basis for determining the steps that need to be taken (enactment of new laws or amendment of existing laws) as part of the action plan.

Phase 2: Reviewing the practical application of supervisory policies and procedures

25. The second phase of the self-assessment consists of reviewing the practical application of supervisory policies and procedures. This phase is crucial as it determines whether legal requirements are enforced in practice. In effect, the purpose of phase 2 is to check whether the judgement on compliance against the overall legal framework is to be amended after reviewing current practices, since those may deviate from what is prescribed by laws and/or supervisory guidelines. Furthermore, providing comments on policies and procedures is vitally important in establishing that the various criteria are being implemented in practice. The results of phase 2 are entered in the third column of the table displaying the results of the self-assessment (see the Appendix).

26. In phase 2, the review can lead to several different types of conclusions:

- the assessor may find that the legal texts are not implemented in practice;
- the assessor may find that the policies and procedures followed by banks and their supervisory authority satisfy a given criterion, despite the fact that they are not supported by specific legal provisions;
- the assessor may find that the policies and procedures followed in practice reinforce the legal framework.

27. When the assessment reveals that the legal text is not implemented in practice, the criterion is not complied with. Where legal requirements and actual practice are not consistent, the assessor needs to judge the extent to which the supervisory authority's discretionary policies and procedures make up for the lack of formal legal authority. The authorities would need to take steps to have the formal framework amended so as to correspond more closely to the actual practice.

28. The types of conclusions that may be reached in phase 2 are not meant to be exhaustive. Moreover, the assessor may encounter situations in which the assessment of a criterion is mixed: the legal texts and informal practices may fully satisfy a criterion in some respects while falling short to a greater or lesser degree in other respects. Ultimately, the task of the assessor is to determine that banking laws and supervisory policies and practices are appropriate and effective.

Phase 3: Assessment of compliance with the Core Principles

29. Under phase 3, the assessors determine the extent of compliance, Principle by Principle, based on the overall findings of phases 1 and 2. The assessment of the banking supervisory system against the benchmark of the Core Principles Methodology follows directly from the assessment of the strengths and weaknesses in the previous two phases. Consequently, Phase 3 leads to one of the following four conclusions for each Principle.[1]

- compliant,

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[1] For complete definitions of these terms refer to *Core Principles Methodology*, paragraph 13, pages 52-53. Also, in certain rare instances, a criterion may be considered "not applicable" due to the nature of the banking system or the supervisory framework.

- largely compliant,
- materially non compliant, and
- non-compliant.

The last three categories may also indicate whether steps are being undertaken to address the issue.[2] The assessment would be designated in the fourth column of the table as illustrated in the Appendix.

30. Compliance with the Core Principles is assessed primarily against the essential criteria. A supervisory system can be in compliance with a particular Principle even when additional criteria are not met. The self-assessment, however, should review the extent of compliance with all criteria, including those considered additional. Additional criteria relate to best practices for supervisors and will also be a valuable tool in the development of an action plan. Reviewing compliance against both categories increases the likelihood that the supervisory regime will keep up with best practices. A supervisory authority may opt to have their self-assessment formally cover all of the criteria, including the additional criteria.

31. The task of the assessor is to determine the compliance, taking into account the subtleties of the supervisory system, and make a judgement as to which category most accurately conveys the situation. It should not be assumed, for example, that compliance with all essential criteria would mean that a Principle is fully implemented. This may be particularly the case when taking into account the interaction between different Principles. Several of the Core Principles (e.g. capital adequacy, Core Principle 6) can only be assessed with an appreciation of the reliability of accounting and valuation practices and the independence and competence of the external audit profession. These interactions should be carefully evaluated when determining the actual level of compliance for each Principle.

Phase 4: Drawing up an Action Plan

32. The purpose of phase 4 is to draw up an action plan to address identified weaknesses. The action plan should prioritise the steps needed to address the identified deficiencies, taking into account and describing the economic realities and resources available. The identification of a discrepancy between supervisory requirements as they are applied in practice, on the one hand, and the standards set by the *Core Principles Methodology,* on the other hand, leads to at least four possibilities:

- The supervisory authority may choose to correct the deficiency if the matter at issue falls within the authority's legal competence.
- If the issue falls outside the supervisory authority's competence, it may recommend to other national authorities, or, if it is a matter of strengthening the supervisory authority's legal powers, to the legislature, the corrective actions needed.
- The supervisory authority may judge that the Principle is not applicable to its domestic banking system. For example, the supervisor of a banking system with no cross-border activities may see little to be gained by upgrading the requirements relating to global consolidated supervision (Core Principle 23).

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[2] *Ibid*, paragraph 16, page 53.

- The discrepancy may be justified by local circumstances. For example, in some countries, functions that elsewhere are carried out by bank supervisors are carried out instead by non-supervisory authorities.

33. The action plan should list recommendations for addressing deficiencies identified, along with a timetable for carrying out reforms. As mentioned above, remedies should not be limited to improvements in supervisory policies and practices that the supervisory authority can make on its own, but should also include, where needed, requests to the legislature for enactment of new laws or amendments to existing laws, and requests to other authorities for reforms that fall within their competence.

34. Ideally, the implementation of the action plan will lead to a co-operative effort involving the various government agencies involved in bank supervision and regulation, as well as members of the banking profession and other members of the financial community.

III. The self-assessment report

35. The final stage of the self-assessment process is the preparation of a report summarising the findings of the self-assessment and setting out the Action Plan. The report should cover a range of elements and may be structured as follows:

A. The organisation of banking supervision

36. The report should open with a description of the organisation of banking supervision. This section should provide a description of the legal framework that underlies the supervisory process, and any relevant historical developments. The discussion should also summarise recent changes in the banking law.

37. The report should identify and describe the functions of each official agency involved in supervision, distinguishing those that supervise the day-to-day activities of banks from those that conduct other aspects of banking supervision such as licensing. A chart showing each agency and the sector or institutions that it supervises, with indications of any multiple regulators, could be annexed to the report. This description should cover each agency's mission, composition, primary responsibilities, number of supervisory staff, and regulatory and enforcement powers. A section should be devoted to describing the inter-relationship of the various authorities, and the mechanisms for cooperation among them. This section should also mention the relationship among agencies (e.g. legislative, judicial, etc.), and the mechanisms for cooperation with other domestic and foreign supervisors. It should also note any features of the commercial, legal, or political infrastructure that impede effective supervision in any way. It is possible that the local context will render one or more of the Core Principles criteria inapplicable, but such instances should be recognised explicitly and evaluated objectively, rather than simply dismissed as a matter of local discretion.

38. The report should also describe key domestic accounting standards and practices and the role that supervisors play in developing such standards and practices.

B. An overview of the banking system

39. An overview of the banking system detailing the number of banks (and, where applicable, "quasi-banks") supervised, the nature of their activities as well as their structure (e.g., subsidiaries

or branches of foreign banks) should be provided. This will put into context the banking system that banking supervision is intended to cover.

C. Documents reviewed

40. The self-assessment report should provide information on the types of material reviewed in order to assess compliance with the Core Principles. The report should also mention any external agencies from which this material was received.

D. Assessment of compliance and Action Plan

41. This section of the report should set out the conclusions and recommendations made in phases 3 and 4 of the self-assessment. As mentioned above, keeping in mind the relationship of the self-assessment to the external assessment, it may be helpful that the report of the results of the self-assessment follow the format used by the IMF and World Bank in their external assessments.[3] The core of the report should be a Principle-by-Principle assessment followed by the Action Plan. In addition, the report may include recommendations regarding subsequent self-assessments that could be used to check progress on the Action Plan.

42. The overall assessment may be facilitated by drawing up a table of results, using the following format:

[3] *Ibid*, page 50.

Overview of Action Plan

Principles	Type of Criteria		Compliance					Action Plan	Target date for Implementation
	EC	AC	C	LC	MNC	NC	NA		
Principle 4	1 2 3	 1	x x x x						
Principle 5	1 2 3 4		x x x	 X					

EC: essential criteria
AC: additional criteria

C Compliant
LC: Largely compliant
MNC: Materially non compliant

NC: Non-compliant
NA: Not applicable

E. Dissemination and publication of the results of the self-assessment

43. The self-assessment report should be endorsed by senior management of the supervisory authority. The results should be discussed with all agencies involved in the banking supervisory process. The supervisors should consider sharing the report with the IMF and World Bank with a view to facilitating the conduct of external assessments conducted by these institutions. Such assessments are conducted on either a stand-alone basis or as part of an assessment of a country's financial sector (Financial Sector Assessment Program or FSAP).

44. The supervisory authority in each country will need to weigh the pros and cons of making public the results of the self-assessment exercise. Disclosing the findings of the self-assessment can enhance the commitment of all staff of the supervisory authority to work toward the necessary changes set out in the Action Plan. In addition, it will put pressure on other relevant national authorities (e.g., the Congress or Ministry of Finance) to support the changes through legislation, increased budgets and other means. Conversely, disclosure may cause the assessors to take a less critical view of the supervisory framework and encourage the supervisory authority to mask or ignore key shortcomings. It may also cause other national authorities to criticise openly the supervisory authority rather than working with it to make the necessary changes. For these reasons, at the completion of a self-assessment, the supervisory authority will need to judge whether it would be beneficial to publish the results of the exercise.

45. The form of disclosure can also vary based on the judgement of the supervisory authority. Some may choose to publish the full report while others may publish only a summary of the results.

Appendix

Sample Compilation of the Results of Phases 1-3 of an Assessment of Core Principle #12

Principle 12: Banking supervisors must be satisfied that banks have in place systems that accurately measure 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

Criteria	**Phase 1 Legal Framework***	**Phase 2 Practices and Procedures**	**Phase 3 Compliance**					
			Assessment					**Comments**
Essential			**C**	**LC**	**MNC**	**NC**	**NA**	
1. The supervisor determines that a bank has suitable policies and procedure related to the identification, measuring monitoring and control of market risk.	- *Regulation 95-02 relating to prudential monitoring of market risks.* - *Regulation 97-02 (relating to internal control in the credit institution – art.25 to art. 27-)* - *Credit institutions must have risk measurement systems to allow them to access risks on a consolidated basis (art.17).* - *Regulation 97-04 relating to the management standards applicable to investment firms (art. 1 to 3).*	*Evaluation and special analysis on specific market risk are carried out by off-site supervisors (frequent analysis by themes).*	X					
2 The supervisor determines that the bank has set appropriate limits for various market risks, including their foreign exchange business.	- *Credit institutions shall have systems to record their trading and foreign transactions on at least a day basis, calculate the related profit and loss and determine positions with the same frequency. They operate also on a day to day basis for risks resulting from trading book positions (art. 7 of reg. 95-02) as well as the adequacy of the institution's capital (art. 25).* - *Regulation 97-02 (art. 33) on limits for market activities.*	- *The overall limits must be traditionally defined by type of exposure.* - *Follow up the use of limits by large banking organisations. For individual banks, supervisors check annual reports and assess the respect of limits. When no compliance is identified, the agency may issue warnings and take more stringent actions needed.*	X					

* Legal citations are only for illustrative purposes.