Basel Committee on Banking Supervision

# BCP

## Core Principles for effective banking supervision

## BCP20

## Assessment methodology

This chapter describes the assessment methodology.

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First version in the consolidated Basel Framework.

BANK FOR INTERNATIONAL SETTLEMENTS

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**20.1**

The Core Principles are intended mainly to help countries assess the quality of their systems and to provide input into their reform agenda. Assessing a country's compliance with the Core Principles is a useful tool for promoting the implementation of an effective system of banking supervision. To promote objectivity and comparability of compliance with the Core Principles in the different country assessments, supervisors and assessors should refer to this assessment methodology, which does not eliminate the need for both parties to use their judgment in assessing compliance. 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 banking supervisors.

**20.2**

While the publication of the assessments of jurisdictions affords transparency, an assessment of one jurisdiction will not be directly comparable with that of another. First, assessments have to reflect proportionality. Thus, a jurisdiction that is home to many systemically important banks will naturally have a higher hurdle to clear to obtain a "compliant" grading than a jurisdiction which only has small, non-complex deposit-taking institutions. Second, jurisdictions can elect to be graded against essential criteria only or against both essential criteria and additional criteria. Third, assessments will inevitably be country-specific and time-dependent to varying degrees. Therefore, the description provided for each Core Principle and the qualitative commentary accompanying the grading for each Core Principle should be reviewed to gain an understanding of a jurisdiction's approach to the specific component under consideration and the need for any improvements. Seeking to compare countries by simply referring to the number of "compliant" and "non-Compliant" grades they receive is unlikely to be informative.

**20.3**

From a broader perspective, effective banking supervision is dependent on a number of external elements, or preconditions, which may not be within the direct jurisdiction of supervisors. The review of the preconditions is qualitative and distinct from the assessment (and grading) of compliance with the Core Principles.

### Use of the assessment methodology

**20.4**

The assessment methodology can be used in multiple contexts:

1. self-assessments performed by banking supervisors themselves;
2. IMF and World Bank assessments of the quality and effectiveness of supervisory systems, for example in the context of the FSAP;
3. reviews conducted by private third parties such as consulting firms; or
4. peer reviews conducted, for instance, within regional groupings of banking supervisors.

**20.5**

Whatever the context, the following factors are crucial:

1. A recent self-assessment of compliance with the Core Principles is an essential exercise for supervisors to have undertaken, since it will provide an important indicator of where techniques and practices need to be strengthened.

2. To promote objectivity, compliance with the Core Principles is best assessed by two suitably qualified external individuals with strong supervisory backgrounds who bring varied perspectives so as to provide checks and balances.
3. A fair assessment of the banking supervisory process cannot be performed without the genuine cooperation of all relevant authorities.
4. The process of assessing each of the 29 principles requires a judgmental weighing of various elements that only qualified assessors with practical, relevant experience can provide.
5. The assessment requires some legal and accounting expertise in the interpretation of compliance with the Core Principles in relation to the legislative and accounting structure of the relevant country.
6. The assessment must be comprehensive and in sufficient depth to allow a judgment on whether criteria are fulfilled in practice and not just in theory. Laws and regulations need to be sufficient in scope and depth, and they must be effectively enforced and complied with. Their existence alone does not provide sufficient indication that the criteria are met.

**Assessment of compliance**

**20.6**

The primary objective of an assessment is to identify the nature and extent of any weaknesses in banking supervision. While the process of implementing the Core Principles starts with the assessment of compliance, assessment is a means to an end, not an objective in itself. The assessment allows the supervisory authority (and in some instances the government) to initiate a strategy to improve the banking supervisory system, as necessary.

**20.7**

The assessment methodology for the Core Principles includes both essential and additional assessment criteria:

1. Essential criteria are minimum baseline requirements for sound supervisory practices and are universally applicable to all countries. An assessment of a country against the essential criteria must recognise that its supervisory practices should be commensurate with the risk profile and systemic importance of the banks being supervised; that is, the assessment must consider the context in which the supervisory practices are applied.
2. Additional criteria are suggested best practices that countries with more complex banks should aim for. Effective banking supervisory practices are not static. They evolve over time as lessons are learnt and banking business continues to develop and expand. Supervisors are often swift to encourage banks to adopt "best practice" and should "practise what they preach" by seeking to move continually towards the highest supervisory standards. To reinforce this aspiration, the additional criteria in the Core Principles set out supervisory practices that exceed current baseline expectations but which contribute to the robustness of individual supervisory frameworks. As supervisory practices evolve, it is expected that upon each revision of the Core Principles, a number of additional criteria will become essential criteria, as expectations of baseline standards change. The use of essential criteria and additional criteria will, in this sense, contribute to the continuing relevance of the Core Principles over time.

**20.8**

Countries undergoing assessment by the IMF and/or the World Bank have the following three assessment options:

1. Unless the country explicitly selects another option, compliance with the Core Principles will be assessed and graded only with reference to the essential criteria;
2. A country may voluntarily choose to be assessed against the additional criteria to identify areas in which it could enhance its regulation and supervision further and benefit from assessors' comments on how this could be achieved. However, compliance with the Core Principles will still be graded only with reference to the essential criteria; or
3. To accommodate countries that seek to attain best supervisory practices, a country may voluntarily choose to be assessed and graded against both the essential and the additional criteria. It is anticipated that this will provide incentives to jurisdictions, particularly those that are important financial centres, to lead the way in the adoption of the highest supervisory standards.

**20.9**

For assessments of the Core Principles by external parties, the following four-grade scale will be used. A "not applicable" grading can be used under certain circumstances as described in BCP20.10.

1. Compliant – A country will be considered compliant with a principle when all essential criteria applicable for this country are met without any significant deficiencies. There may be instances in which a country can demonstrate that the principle has been achieved by other 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 evidence of other measures may also be needed in order for the aspect of banking supervision addressed by the principle to be considered effective.
2. Largely compliant – A country will be considered largely compliant with a principle if only minor shortcomings are observed that do not raise any concerns about the authority's ability and clear intent to achieve full compliance with the principle within a prescribed period of time. The assessment "largely compliant" can be used if the system does not meet all essential criteria but the overall effectiveness is sufficiently good and no material risks are left unaddressed.
3. Materially non-compliant – A country will be considered materially non-compliant with a principle if there are severe shortcomings (despite the existence of formal rules, regulations and procedures) and there is evidence that supervision has clearly not been effective, that practical implementation is weak, or that the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. It is acknowledged that the "gap" between "largely compliant" and "materially non-compliant" is wide, and that the choice may be difficult. However, the intention is to force the assessors to make a clear statement.
4. Non-compliant – A country will be considered non-compliant with a principle if there has been no substantive implementation of the principle, several essential criteria have not been complied with, or supervision is manifestly ineffective.

**20.10**

In addition, a principle will be considered "not applicable" if, in the view of the assessor, the principle does not apply given the structural, legal and institutional features of the country. In some instances, countries have argued that in the case of certain embryonic or immaterial banking activities, which were not being supervised, an assessment of "not applicable" should have been given, rather than "non-compliant". This is an issue for judgment by the assessor, although activities that are relatively insignificant at the time of assessment may later assume greater importance and authorities need to be aware of and prepared for such developments. The supervisory system should permit such activities to be monitored, even if no regulation or supervision is considered immediately necessary. "Not applicable" would be an appropriate assessment if the supervisors are aware of the phenomenon and capable of taking action, but there is realistically no chance that the activities will grow sufficiently in volume to pose a risk.

**20.11**

Grading is not an exact science, and the Core Principles can be met in different ways. The assessment criteria should not be seen as a checklist approach to compliance but as a qualitative exercise. Compliance with some criteria may be more critical for effective supervision, depending on the situation and circumstances in a given jurisdiction. Hence, the number of criteria complied with is not always an indication of the overall compliance rating for any given principle. Emphasis should be placed on the commentary that should accompany each principle's grading, rather than on the grading itself. The primary goal of the exercise is not to apply a "grade" but rather to direct authorities towards areas needing attention to set the stage for improvements and develop an action plan that prioritises the improvements needed to achieve full compliance with the Core Principles.

**20.12**

The assessment should also include the assessors' opinion of how weaknesses in the preconditions for effective banking supervision, as discussed in BCP30, hinder effective supervision and of how effectively supervisory measures mitigate these weaknesses. In particular, the assessment of compliance with individual Core Principles should clearly mention how compliance is likely to be primarily affected by preconditions that are considered to be weak. This opinion should be qualitative rather than providing any kind of graded assessment. To the extent that shortcomings in preconditions are material to the effectiveness of supervision, they may affect the grading of the affected Core Principles.

**Practical considerations in conducting an assessment**

**20.13**

While the Committee does not provide detailed guidelines on the preparation and presentation of assessment reports, it believes there are a few considerations that assessors should consider when conducting an assessment and preparing the assessment report.

**20.14**

When conducting an assessment, the assessor must have free access to a range of information and interested parties. The required information may include not only 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 supervisors' legal obligations to keep such information confidential. Experience from assessments has shown that secrecy issues can often be solved through ad hoc arrangements between the assessor and the assessed authority. The assessor will need to meet 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 of instances when required information is not provided and of the impact this might have on the accuracy of the assessment.

**20.15**

The assessment of compliance with each principle requires the evaluation of a chain of related requirements which, depending on the principle, may encompass laws, prudential regulations, supervisory guidelines, on-site examinations and off-site analyses, supervisory reporting and public disclosures, and evidence of enforcement or non-enforcement. The assessment must ensure that the requirements are put into practice, which entails assessing whether the supervisory authority has the necessary operational autonomy, skills, resources and commitment to implement the Core Principles. The assessment must confirm that the supervisor has the relevant powers and exercises them, where appropriate.

**20.16**

It is important to bear in mind that some tasks, such as assessing the macroeconomic environment and detecting the build-up of dangerous trends, do not lend themselves to a rigid compliant/non-compliant structure. Although these tasks may be difficult to undertake, supervisors should aim for assessments that are as accurate as possible given the information available at the time and take reasonable actions to address and mitigate such risks.

**20.17**

Assessments should not focus solely on deficiencies but should also highlight specific achievements. This approach will provide a better picture of the effectiveness of banking supervision.

**20.18**

There are certain jurisdictions where non-bank financial institutions that are not part of a supervised banking group engage in some bank-like activities. These institutions may make up a significant portion of the total financial system and may be largely unsupervised. Since the Core Principles deal specifically with banking supervision, they cannot be used for formal assessments of these institutions. However, the assessment report should, at a minimum, mention any activities in which non-bank financial intermediation has an impact on supervised banks and the potential problems that may arise as a result of such activities.

**20.19**

The development of cross-border banking leads to increased complications when conducting Core Principles assessments. Improved cooperation and information-sharing between home and host country supervisors is of central importance, both in normal times and in crisis situations. The assessor must therefore determine whether such cooperation and information-sharing actually takes place to the extent needed, bearing in mind the size and complexity of the banking links between the two countries.

**20.20**

For the purposes of assessing risk management by banks in the context of Principles 15 to 25, a bank's risk management framework should take an integrated bank-wide perspective of its risk exposure, encompassing individual business lines and business units. Where a bank is a member of a group, the risk management framework should also cover the risk exposure across and within the banking group and take account of risks posed to the bank or banking group by other entities in the wider group.

**20.21**

Assessment of Principle 29 (Abuse of financial services) will, for some countries, involve a degree of duplication with the mutual evaluation process of the Financial Action Task Force (FATF). To address this overlap, where an evaluation has recently been conducted by the FATF on a given country, FSAP assessors may rely on that evaluation and focus their own review on the actions taken by supervisors to address any shortcomings identified by the FATF. In the absence of any recent FATF evaluation, FSAP assessors should continue to assess countries' supervision of banks' AML/CFT controls.