

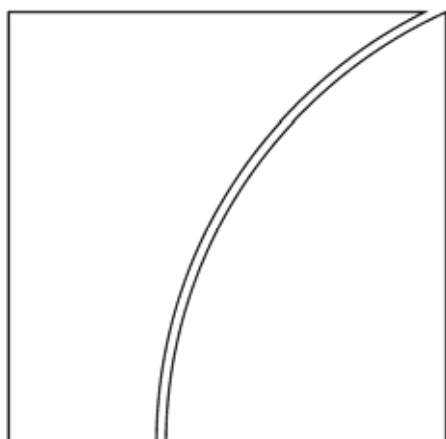
# Basel Committee on Banking Supervision

## Consultative Document

### Core Principles Methodology

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## Core Principles Methodology

***This document, when finalised, is intended to supersede the 1999 Core Principles Methodology. Comments on this consultative document are welcome and should be submitted to the Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland by 23 June 2006. Comments may also be submitted by email: [baselcommittee@bis.org](mailto:baselcommittee@bis.org) or by fax: +41 61 280 9100.***

### Introduction

1. The *Core Principles for Effective Banking Supervision*, developed by the Basel Committee on Banking Supervision (the Committee) in cooperation with fellow supervisors, have become de facto the standard for sound prudential regulation and supervision of banks. The Core Principles are mainly intended to help countries assess the quality of their systems and to provide input into their reform agenda. The vast majority of countries have endorsed the Core Principles and have declared their intention to implement them.

2. An assessment of the current situation of a country's compliance with the Principles can be considered a useful tool in a country's implementation of an effective system of banking supervision. In order to achieve objectivity and comparability in the different country assessments of compliance with the Principles,<sup>1</sup> the Committee has developed this Methodology, which does not eliminate the need for both supervisors and assessors 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.

3. Although Committee members individually collaborate in assessment missions, these are conducted primarily by the IMF and the World Bank. The Committee has decided not to make assessments of its own to maintain the current division of labour between the Committee's standard-setting and the international financial institutions' assessment functions. However, the Committee, together with the Financial Stability Institute, is prepared to assist in other ways, for example by providing training.

4. The rest of the document is structured as follows: the remainder of this introductory section contains some general statements about the use of the Methodology, the assessment of compliance (including the definition of the grading system), practical considerations in conducting the assessment, and the treatment of Basel II in the Core Principles; this is followed by a section listing in detail the criteria for assessing compliance with the Core Principles.

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<sup>1</sup> The aim of assessments is, however, not for ranking supervisory systems.

## Use of the Methodology

5. The Methodology can be used in multiple contexts: (i) self-assessment performed by banking supervisors themselves;<sup>2</sup> (ii) IMF and World Bank assessments of the quality of supervisory systems, for example in the context of the Financial Sector Assessment Program; (iii) reviews conducted by private third parties such as consulting firms; or (iv) peer review conducted, for instance, within regional groupings of banking supervisors. At the time of writing, assessments of compliance have already been conducted in more than 100 countries and others are under way.<sup>3</sup>

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

- In order to achieve full objectivity, compliance with the Core Principles is best assessed by suitably qualified outside parties consisting of two individuals with strong supervisory backgrounds who bring varied perspectives so as to provide checks and balances; however, experience has shown that a recent self-assessment is a highly useful input to an outside party assessment.
- A fair assessment of the banking supervisory process cannot be performed without the genuine cooperation of all relevant authorities.
- The process of assessing each of the 25 Principles requires a judgmental weighing of numerous elements that only qualified assessors with practical, relevant experience can provide.
- The assessment requires some legal and accounting expertise in the interpretation of compliance with the Core Principles; these legal and accounting interpretations must be in relation to the legislative and accounting structure of the relevant country. They may also require the advice of additional legal and accounting experts, which can be sought subsequent to the on-site assessment.
- The assessment must be comprehensive and in sufficient depth to allow a judgment on whether criteria are fulfilled in practice, not just in theory. Laws and regulations need to be sufficient in scope and depth, and be effectively enforced and complied with. Their existence alone does not provide enough indication that the criteria are met.

## Assessment of compliance

7. 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. 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. Instead, the assessment will allow the supervisory authority (and in some instances the government) to initiate a strategy to improve the banking supervisory system, as necessary.

8. To assess compliance with a Principle, the Methodology proposes a set of essential and additional assessment criteria for each Principle. The essential criteria are the only elements on which to gauge full compliance with a Core Principle. The additional criteria are suggested best practices which countries having advanced banks should aim for. The

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<sup>2</sup> The Basel Committee has issued guidelines for performing self-assessments: *Conducting a supervisory self-assessment – practical application*, Basel, April 2001.

<sup>3</sup> The regular reports issued by the IMF on the lessons drawn from assessment experiences as part of FSAP exercises constitute a useful source of information which has been used as an input to improve the Principles.



additional criteria will not be used for assessing compliance with the Core Principles but a country may, voluntarily and in terms of comments rather than compliance grades, also choose to be assessed against the additional criteria, in order to identify areas in which it could enhance its regulation and supervision further.

9. For assessments of the Principles by external parties,<sup>4</sup> the following four-grade scale will be used: compliant, largely compliant, materially non-compliant, and non-compliant. A “not applicable” grading can be used under certain circumstances as described in paragraph 11.

10 Brief description of gradings and their applicability:

- 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, of course, where 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 other measures may also be needed in order for the aspect of banking supervision addressed by the Principle to be considered effective.
- Largely compliant – A country will be considered largely compliant with a Principle whenever only minor shortcomings are observed which 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 when the system does not meet all essential criteria, but the overall effectiveness is sufficiently good, and no material risks are left unaddressed.
- Materially non-compliant – A country will be considered materially non-compliant with a Principle whenever 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. On the other hand, the intention has been to force the assessors to make a clear statement.
- Non-compliant – A country will be considered non-compliant with a Principle whenever there has been no substantive implementation of the Principle, several essential criteria are not complied with or supervision is manifestly ineffective.

11. In addition, a Principle will be considered not applicable when, in the view of the assessor, the Principle does not apply given the structural, legal and institutional features of a 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 which 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

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<sup>4</sup> In the case of self-assessments, gradings have virtually no relevance.

phenomenon, and would be capable of taking action, but there is realistically no chance that the activities will grow sufficiently in volume to pose a risk.

12. Grading is not an exact science and the 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. Moreover, not every criterion carries equal weight and 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 grading, rather than on the grading itself. The primary goal of the exercise is not to apply a “grade” but rather to focus authorities on areas needing attention in order to set the stage for improvements and develop an action plan that prioritises the improvements needed to achieve full compliance with the Core Principles.

13. The assessment should also include the assessors’ opinion on how weaknesses in the preconditions for effective banking supervision, as discussed in the Core Principles document (paragraphs 11-15), hinder effective supervision and how effectively supervisory measures mitigate these weaknesses. This opinion should be qualitative rather than providing any kind of graded assessment. Recommendations with regard to the preconditions for effective banking supervision can also be included in the action plan. It should also indicate the actions needed to address any shortcomings and areas where a follow-up assessment may be warranted.

14. The Core Principles are minimum standards to be applied by all banking supervisors. In implementing some of them, supervisors will need to take into account the risk profile, size and complexity of individual banks, particularly for those Core Principles where supervisors have to determine the adequacy of banks' risk management policies and processes.

### **Practical considerations in conducting an assessment**

15. While the Basel Committee does not have a specific role in setting out detailed guidelines on the 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. By way of example, the annex to this document includes the format developed by the IMF and the World Bank for conducting their own assessments of the state of implementation of the Core Principles in individual countries. This annex also includes structured guidance to the assessors on how to form an opinion on the preconditions for effective banking supervision, how weaknesses in these external elements may hinder supervision, as mentioned in paragraph 13, and how effectively supervisory measures can mitigate shortcomings in the preconditions for effective banking supervision.

16. First, 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 legal requirements for supervisors to hold 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 institution. 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 of instances when any

required information is not provided, as well as of what impact this might have on the accuracy of the assessment.

17. 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. Further, the assessment must ensure that the requirements are put into practice. This also requires assessing whether the supervisory authority has the necessary operational autonomy, skills, resources and commitment to implement the Core Principles.

18. Third, 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.

19. Fourth, 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 non-bank financial institutions. However, the assessment report should, at a minimum, mention those activities where non-banks have an impact on the supervised banks and the potential problems which may arise as a result of non-bank activities.

20. Fifth, 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 that 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.

### **Treatment of Basel II in the Core Principles**

21. There is no Core Principle requiring a country to comply with the capital adequacy regime of Basel II. Basel II compliance is only required of those countries which have declared that they have voluntarily implemented it. The Committee does not consider the implementation of Basel II a prerequisite for compliance with the Core Principles. The Committee published the revised capital adequacy framework with a view to encouraging supervisory authorities worldwide to consider adopting it at such time as they believe is consistent with their broader supervisory priorities. While Basel II has been designed to provide options for banks and banking systems worldwide, the Committee acknowledges that moving towards its adoption may not be a first priority for all supervisory authorities in terms of what is needed to strengthen their supervision. Where this is the case, each national supervisor should consider carefully the benefits of Basel II in the context of its domestic banking system when developing a timetable and approach to implementation.

22. In this revised version of the Core Principles and the assessment criteria, amendments have been made to incorporate a number of sound supervisory practices. Some of these practices, for instance in the areas of risk management and disclosure, are as important for Basel II countries and for all countries and have thus been included among the essential criteria. As noted above, several “best practices” have been included among the additional criteria, which countries having advanced banking systems should aim for.

## Criteria for assessing compliance with the Core Principles

23. This section lists the assessment criteria for each of the 25 Core Principles under two separate headings: “essential criteria” and “additional criteria”. As mentioned in paragraph 8, essential criteria are those elements that should be present in order to demonstrate compliance with a Principle. Additional criteria may be particularly relevant to the supervision of more sophisticated banking organisations, and countries with such institutions should aim to achieve them. However, the compliance grading will be based solely on the essential criteria; the assessor will comment on, but not grade, compliance with the additional criteria.

24. The individual assessment criteria are based on sound supervisory practices already established, even if they are not fully implemented yet. Where appropriate, the documents on which the criteria are founded have been cited.

### Principle 1: Objectives, independence, powers, transparency and cooperation

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.<sup>5</sup> Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the overall exercise of its duties. 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: CP 1 is divided into six component parts. Three of the component parts are not repeated elsewhere in the CPs. However, two parts (3 and 4) are developed in greater detail in one or more of the subsequent CPs. For these two, since the criteria will be developed further elsewhere, this section identifies only the most fundamental and crucial ones. Part 6 is enhanced in CPs 18, 24 and 25.*

### Principle 1(1): Responsibilities and objectives

An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks.

#### **Essential criteria**

1. Laws are in place for banking, and for the authority (each of the authorities) involved in banking supervision. The responsibilities and objectives of each of the authorities are clearly defined and publicly disclosed.
2. The laws and supporting regulations provide a framework of minimum prudential standards that banks must meet.

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<sup>5</sup> Such authority is called “the supervisor” throughout this paper, except where the longer form “the banking supervisor” has been necessary for clarification.

3. Banking laws and regulations are updated as necessary to ensure that they remain effective and relevant to changing industry and regulatory practices.
4. The supervisor confirms that information on the financial strength and performance of the industry under its jurisdiction is publicly available.

#### ***Additional criterion***

1. In determining supervisory programmes and allocating resources, supervisors take into account the risks posed by individual banks and banking groups and the different approaches available to mitigate those risks.<sup>6</sup>

#### **Principle 1(2): Independence, accountability and transparency**

Each such authority should possess operational independence, transparent processes, sound governance and adequate resources, and be accountable for the overall exercise of its duties.

#### ***Essential criteria***

1. The operational independence, accountability and governance structures of each supervisory authority are prescribed by law and publicly disclosed. There is, in practice, no evidence of government or industry interference which compromises the operational independence of each authority, or in each authority's ability to obtain and deploy the resources needed to carry out its mandate. The head(s) of the supervisory authority can be removed from office during his (their) term only for reasons specified in law. The reason(s) for removal should be publicly disclosed.
2. The supervisor publishes objectives and is accountable through a transparent framework for the exercise of its duties in relation to those objectives.<sup>7</sup>
3. The supervisory authority and its staff have credibility based on their professionalism and integrity.
4. The supervisor is financed in a manner that does not undermine its autonomy or independence and permits it to conduct effective supervision and oversight. This includes:
  - a budget that provides for staff in sufficient numbers and with skills commensurate with the size and complexity of the institutions supervised;
  - salary scales that allow it to attract and retain qualified staff;

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<sup>6</sup> The concept of risk-based supervision has been adopted by some supervisory authorities since the Core Principles were introduced in 1997. As there is no international consensus on the concept of a risk-based supervisory approach, the Core Principles do not define or require authorities to adopt such an approach. Nevertheless, the 2006 revision of the Core Principles recognises the growing supervisory practice of determining supervisory programmes and allocating resources taking into account the risks posed by individual banks and banking groups.

<sup>7</sup> Please refer to CP 1(1), EC 1.

- the ability to commission outside experts with the necessary professional skills and independence, and subject to necessary confidentiality restrictions to conduct supervisory tasks;
- a training budget and programme that provide regular training opportunities for staff;
- a budget for computers and other equipment sufficient to equip its staff with the tools needed to review the banking industry and assess individual banks and banking groups; and
- a travel budget that allows appropriate on-site work.

### ***Additional criterion***

1. The head(s) of the supervisory authority is (are) appointed for a minimum term.

### **Principle 1(3): Legal framework**

A suitable legal framework for banking supervision is also necessary, including provisions relating to authorisation of banking establishments and their ongoing supervision.<sup>8</sup>

#### ***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 (without changing laws). The supervisor consults publicly on proposed changes, as appropriate.
3. The law or regulations empower the supervisor to require information from the banks and banking groups in the form and frequency it deems necessary.

### **Principle 1(4): Legal powers**

A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws as well as safety and soundness concerns.<sup>9</sup>

#### ***Essential criteria***

1. The law and regulations enable the supervisor to address compliance with laws and the safety and soundness of the banks under its supervision. The law and regulations permit the supervisor to apply qualitative judgment in safeguarding the safety and soundness of the banks within its jurisdiction.

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<sup>8</sup> This component of Principle 1 is amplified in the subsequent Principles.

<sup>9</sup> This component of Principle 1 is amplified in the Principle which addresses “Corrective and remedial powers of supervisors” (23).

2. The supervisor has full access to banks' Board, management, staff and files in order to review compliance with internal rules and limits as well as external laws and regulations.
3. When, in a supervisor's judgment, a bank is not complying with laws or regulations, or it is or is likely to be engaged in unsafe or unsound practices, the supervisor has the power to:
  - take (and/or require a bank to take) prompt remedial action; and
  - impose a range of sanctions (including the revocation of the banking licence).

#### **Principle 1(5): Legal protection**

A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.

##### ***Essential criteria***

1. The law provides protection to the supervisory authority and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith.
2. The supervisory authority and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.

#### **Principle 1(6): Cooperation**

Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.<sup>10</sup>

##### ***Essential criteria***

1. Arrangements, formal or informal, are in place for cooperation and information sharing between all domestic authorities with responsibility for the soundness of the financial system, and there is evidence that these arrangements work in practice, where necessary.
2. Arrangements, formal or informal, are in place, where relevant, for cooperation and information sharing with foreign financial sector supervisors of banks and banking groups of material interest to the home or host supervisor, and there is evidence that these arrangements work in practice, where necessary.
3. The supervisor may provide confidential information to another domestic or foreign financial sector supervisor. The supervisor is required to take reasonable steps to ensure that any confidential information released to another supervisor will be used only for supervisory purposes and will be treated as confidential by the receiving party. The supervisor receiving confidential information from other supervisors is

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<sup>10</sup> This component of Principle 1 is developed further in the Principles dealing with "Abuse of financial services" (18), "Consolidated supervision" (24) and "Home-host relationships" (25).

also required to take reasonable steps to ensure that the confidential information will be used only for supervisory purposes and will be treated as confidential.

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: Permissible activities**

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 laws 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 is limited to licensed and supervised institutions in all circumstances where the general public might otherwise be misled.
4. The taking of deposits from the public is generally<sup>11</sup> reserved for institutions that are licensed and subject to supervision as banks.
5. The supervisory or licensing authority publishes, and keeps current, a list of licensed banks and branches of foreign banks operating within its jurisdiction.

## **Principle 3: Licensing criteria**

The licensing authority must have the power 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 ownership structure and governance of the bank and its wider group, including the fitness and propriety of Board members and senior management, its strategic and operating plan, internal controls and risk management, 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 could be the banking supervisor or another competent authority. If the licensing authority and the supervisory authority are not the same,

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<sup>11</sup> The word “generally” allows for the presence in some countries of non-banking financial institutions which may not be supervised in the same manner as banks but do take deposits and provide lending services, given these institutions collectively do not hold a significant proportion of deposits in a financial system. Examples of such institutions are credit unions and microfinance institutions.



- the supervisor has the right to have its views considered on each specific application.
2. The licensing authority has the power to set criteria for licensing banks. These may be based on criteria set in laws or regulations.
  3. The criteria for issuing licences are consistent with those applied in ongoing supervision.
  4. The licensing authority has the power to reject an application if the criteria are not fulfilled or if the information provided is inadequate.
  5. The licensing authority determines that the proposed legal, managerial and ownership structures of the bank and its wider group will not hinder effective supervision on both a solo and a consolidated basis.<sup>12</sup>
  6. The licensing authority identifies and determines the suitability of major shareholders, including the ultimate beneficial owners, and others that may exert significant influence. It also assesses the transparency of the ownership structure and the sources of initial capital.
  7. A minimum initial capital amount is stipulated for all banks.
  8. The licensing authority, at authorisation, evaluates proposed directors and senior management as to expertise and integrity (fit and proper test), including the potential for conflicts of interest. The fit and proper criteria include: (i) skills and experience in relevant financial operations commensurate with the intended activities of the bank; and (ii) no record of criminal activities or adverse regulatory judgments that make a person unfit to uphold important positions in a bank.<sup>13</sup>
  9. The licensing authority reviews the proposed strategic and operating plans of the bank. This includes determining that an appropriate system of corporate governance, risk management and internal controls, including those related to the detection and prevention of criminal activities, as well as the oversight of proposed outsourced functions, will be in place. The operational structure is required to reflect the scope and degree of sophistication of the proposed activities of the bank.<sup>14</sup>
  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. In the case of foreign banks establishing a branch or subsidiary, prior consent (or a statement of “no objection”) of the home country supervisor should be obtained.
  12. If the licensing, or supervisory, authority determines that the licence was based on false information, the licence can be revoked.

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<sup>12</sup> Therefore, shell banks shall not be licensed.  
(Reference document: *BCBS paper on shell banks*, 2003).

<sup>13</sup> Please refer to CP 17, EC 4.

<sup>14</sup> Please refer to CP 18.

### **Additional criteria**

1. The assessment of the application includes the ability of the shareholders to supply additional financial support, if needed.
2. The Board, collectively, must have a sound knowledge of each of the types of activities the bank intends to pursue and the associated risks.
3. The licensing or supervisory authority has policies and processes 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: Transfer of significant ownership**

The supervisor has the power to review and reject any proposals to transfer significant ownership or controlling interests held directly or indirectly in existing banks to other parties.

(Reference documents: *Parallel-owned banking structures*, January 2003; and *Shell banks and booking offices*, January 2003.)

### **Essential criteria**

1. Laws or regulations contain clear definitions of “significant” ownership and “controlling interest”.
2. There are requirements to obtain supervisory approval or provide immediate notification of proposed changes that would result in a change in ownership, including beneficial ownership, or the exercise of voting rights over a particular threshold or change in controlling interest.
3. The supervisor has the power to reject any proposal for a change in significant ownership, including beneficial 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.
4. The supervisor obtains from banks, through periodic reporting or on-site examinations, the names and holdings of all significant shareholders or those that exert controlling influence, including the identities of beneficial owners of shares being held by nominees, custodians and through vehicles which might be used to disguise ownership.
5. The supervisor has the power to take appropriate action to modify, reverse or otherwise address a change of control that has taken place without the necessary notification to or approval from the supervisor.

### **Additional criterion**

1. Laws or regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder.

## **Principle 5: Major acquisitions**

The supervisor has the power to review major acquisitions or investments by a bank, against prescribed criteria, including the establishment of cross-border operations, and confirming 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 prior supervisory approval.
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 can prohibit banks from making major acquisitions/investments (including from establishing foreign branches or subsidiaries) in countries with secrecy laws or other regulations prohibiting information flows deemed necessary for adequate consolidated supervision.
4. The supervisor determines that the bank has, from the outset, adequate financial and organisational resources to handle the acquisition/investment.
5. 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.
6. The supervisor is aware of the risks that non-banking activities can pose to a banking group and has the means to take action to mitigate those risks.

### ***Additional criterion***

1. When a bank wishes to acquire a significant holding in a financial institution in another country, the supervisor should take into consideration the quality of supervision in that country.

## **Principle 6: Capital adequacy**

Supervisors must set prudent and appropriate 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. At least for internationally active banks, these requirements must not be less than those established in the applicable Basel requirement.<sup>15</sup>

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<sup>15</sup> The Basel Capital Accord was designed to apply only to internationally active banks, which must calculate and apply capital adequacy ratios on a consolidated basis, including subsidiaries undertaking banking and financial business. Jurisdictions adopting the new capital adequacy framework would apply such ratios on a

(Reference documents: *International convergence of capital measurement and capital standards*, July 1988; and *International convergence of capital measurement and capital standards: a revised framework*, June 2004.)

### **Essential criteria**

1. Laws or regulations require all banks to calculate and consistently maintain a minimum capital adequacy ratio. Laws, regulations or the supervisor define the components of capital, ensuring that emphasis is given to those elements of capital available to absorb losses.
2. At least for internationally active banks, the definition of capital, the method of calculation and the ratio required are not lower than those established in the applicable Basel requirement.
3. The supervisor has the power to impose a specific capital charge and/or limits on all material risk exposures.
4. The required capital ratio reflects the risk profile of individual banks. Both on-balance sheet and off-balance sheet risks are included.
5. Capital adequacy requirements take into account the conditions under which the banking system operates. Consequently, laws and regulations in a particular jurisdiction may set higher capital adequacy standards than the applicable Basel requirement.
6. Laws or regulations clearly give the supervisor authority to take measures should a bank fall below the minimum capital ratio.
7. Where the supervisor permits banks to use internal assessments of risk as inputs to the calculation of regulatory capital, such assessments must adhere to rigorous qualifying standards and be subject to the approval of the supervisor. If banks do not continue to meet these qualifying standards on an ongoing basis, the supervisor may revoke its approval of the internal assessments.

### **Additional criteria**

1. For non-internationally active banks, the definition of capital, the method of calculation and the capital required are broadly consistent with the principles of applicable Basel requirements relevant to internationally active banks.
2. For non-internationally active banks and their holding companies, capital adequacy ratios are calculated and applied in a manner generally consistent with the applicable Basel requirement, as set forth in the footnote to the Principle.
3. The supervisor has the power to require banks to adopt a forward-looking approach to capital management and set capital levels in anticipation of possible events or changes in market conditions that could have an adverse effect.

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fully consolidated basis to all internationally active banks and their holding companies; in addition, supervisors must test that banks are adequately capitalised on a standalone basis.

4. The supervisor requires adequate distribution of capital within different entities of a banking group according to the allocation of risks.
5. The supervisor may require an individual bank or banking group to maintain capital above the minimum to ensure that individual banks or banking groups are operating with the appropriate level of capital.

### **Principle 7: Risk management process**

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board<sup>16</sup> and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.<sup>17</sup>

(Reference documents: *Enhancing corporate governance for banking organisations*, February 2006)

### **Essential criteria**

1. Individual banks and banking groups are required to have in place comprehensive risk management policies and processes to identify, evaluate, monitor and control or mitigate material risks. The supervisor determines that these processes are adequate for the size and nature of the activities of the bank and banking group and are periodically adjusted in the light of the changing risk profile of the bank or banking group and external market developments. If the supervisor determines that the risk management processes are inadequate, it has the power to require a bank or banking group to strengthen them.
2. The supervisor confirms that banks and banking groups have appropriate risk management strategies that have been approved by the Board. The supervisor also confirms that the Board ensures that policies and processes for risk-taking are developed, appropriate limits are established, and senior management takes the steps necessary to monitor and control all material risks consistent with the approved strategies.
3. The supervisor determines that risk management strategies, policies, processes and limits are properly documented, reviewed and updated, communicated within the bank and banking group, and adhered to in practice. The supervisor determines that

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<sup>16</sup> The Basel Core Principles refer to a management structure composed of a Board of Directors (ie the Board) 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 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 and senior management are used in this paper not to identify legal constructs but rather to label two decision-making functions within a bank.

<sup>17</sup> It should be noted that while, in this and other CPs, the supervisor is required to confirm that banks' risk management policies and processes are being adhered to, the responsibility for ensuring adherence remains with a bank's Board and senior management.

exceptions to established policies, processes and limits receive the prompt attention of and authorisation by the appropriate level of management and the Board where necessary.

4. The supervisor determines that senior management and the Board understand the nature and level of risk being taken by the bank and how this risk relates to adequate capital levels. The supervisor also determines that senior management ensures that the risk management policies and processes are appropriate in the light of the bank's risk profile and business plan and that they are implemented effectively. This includes a requirement that senior management regularly reviews and understands the implications (and limitations) of the risk management information that it receives. The same requirement applies to the Board in relation to risk management information presented to it in a format suitable for Board oversight.
5. The supervisor determines that banks have an internal process for assessing their overall capital adequacy in relation to their risk profile, and reviews and evaluates banks' internal capital adequacy assessments and strategies. The nature of the specific methodology used for this assessment will depend on the size, complexity and business strategy of a bank. Non-complex banks may opt for a more qualitative approach to capital planning.
6. Where banks and banking groups use models to measure components of risk, the supervisor determines that banks perform periodic and independent validation and testing of the models and systems.
7. The supervisor determines that banks and banking groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. It is satisfied that these reports are provided on a timely basis to the Board or senior management and reflect the bank's risk profile and capital needs.
8. The supervisor determines that banks have policies and processes in place to ensure that new products and major risk management initiatives are approved by the Board or a specific committee of the Board.
9. The supervisor determines that banks and banking groups have risk evaluation, monitoring, and control or mitigation functions with duties clearly segregated from risk-taking functions in the bank, and which report on risk exposures directly to senior management and the Board.
10. The supervisor issues standards related to, in particular, credit risk, market risk, liquidity risk, interest rate risk in the banking book and operational risk.

#### ***Additional criteria***

1. The supervisor requires larger and more complex banks to have a dedicated unit(s) responsible for risk evaluation, monitoring, and control or mitigation for material risk areas. The supervisor confirms that this unit (these units) is (are) subject to periodic review by the internal audit function.
2. The supervisor requires banks to conduct rigorous, forward-looking stress testing that identifies possible events or changes in market conditions that could adversely impact the bank.

3. The supervisor requires banks and banking groups to have in place appropriate policies and processes for assessing other material risks not directly addressed in the subsequent CPs, such as reputational and strategic risks.

### **Principle 8: Credit risk**

Supervisors must be satisfied that banks have a credit risk management process that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control credit risk (including counterparty risk). This would include the granting of loans and making of investments, the evaluation of the quality of such loans and investments, and the ongoing management of the loan and investment portfolios.<sup>18</sup>

(Reference document: *Principles for the management of credit risk*, September 2000.)

#### **Essential criteria**

1. The supervisor determines, and periodically confirms, that a bank's Board approves, and periodically reviews, the credit risk management strategy and significant policies and processes for assuming,<sup>19</sup> identifying, measuring, controlling and reporting on credit risk (including counterparty risk). The supervisor also determines, and periodically confirms, that senior management implements the credit risk strategy approved by the Board and develops the aforementioned policies and processes.
2. The supervisor requires, and periodically confirms, that such policies and processes establish an appropriate and properly controlled credit risk environment, including:
  - a well documented strategy and sound policies and processes for assuming credit risk;
  - well defined criteria and policies and processes for approving new exposures as well as renewing and refinancing existing exposures, identifying the appropriate approval authority for the size and complexity of the exposures;
  - effective credit administration policies and processes, including continued analysis of a borrower's ability and willingness to repay under the terms of the debt, monitoring of documentation, legal covenants, contractual requirements and collateral, and a classification system that is consistent with the nature, size and complexity of the bank's activities or, at the least, with the asset grading system prescribed by the supervisor;
  - comprehensive policies and processes for reporting exposures on an ongoing basis;
  - comprehensive policies and processes for identifying problem assets; and
  - prudent lending controls and limits, including policies and processes for monitoring exposures in relation to limits, approvals and exceptions to limits.

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<sup>18</sup> Principle 8 covers the evaluation of assets in greater detail; Principle 9 covers the management of problem assets.

<sup>19</sup> "Assuming" includes the assumption of all types of risk that give rise to credit risk, including credit risk or counterparty risk associated with various financial instruments.

3. The supervisor requires, and periodically confirms, that banks make credit decisions free of conflicts of interest and on an arm's length basis.
4. The supervisor has full access to information in the credit and investment portfolios and to the bank officers involved in assuming, managing, controlling and reporting on credit risk.

#### **Additional criteria**

1. The supervisor requires that the credit policy prescribes that major credit risk exposures exceeding a certain amount or percentage of the bank's capital are to be decided by the bank's senior management. The same applies to credit risk exposures that are especially risky or otherwise not in line with the mainstream of the bank's activities.
2. The supervisor determines that banks have in place policies and processes to identify, measure, monitor and control counterparty credit risk exposure, including potential future exposure sufficient to capture the material risks inherent in individual products or transactions. These processes should be commensurate with the size or complexity of the individual bank.
3. The supervisor determines that banks have policies and processes to monitor the total indebtedness of entities to which they extend credit.

#### **Principle 9: Problem assets, provisions and reserves**

Supervisors must be satisfied that banks establish and adhere to adequate policies and processes for managing problem assets and evaluating the adequacy of provisions and reserves.<sup>20</sup>

(Reference documents: *Sound practices for loan accounting and disclosure*, July 1999; and *Principles for the management of credit risk*, September 2000.)

#### **Essential criteria**

1. Laws, regulations or the supervisor require banks to formulate specific policies and processes for identifying and managing problem assets. In addition, laws, regulations or the supervisor require periodic review by banks of their problem assets (at an individual level or at a portfolio level for credits with homogenous characteristics) and asset classification and provisioning.
2. The supervisor confirms the adequacy of the classification and provisioning policies and processes of a bank and their implementation; the reviews supporting this opinion may be conducted by external experts.<sup>21</sup>

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<sup>20</sup> Principle 8 covers the evaluation of assets in greater detail; Principle 9 covers the management of problem assets.

<sup>21</sup> External experts may be external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions. Although supervisors may use



3. The system for classification and provisioning takes into account off-balance sheet transactions.<sup>22</sup>
4. The supervisor determines that banks have appropriate policies and processes to ensure that provisions and write-offs reflect realistic repayment and recovery expectations.
5. The supervisor determines that banks have appropriate policies and processes, and organisational resources for the early identification of deteriorating assets, for ongoing oversight of problem assets, and for collecting on past due obligations.
6. The supervisor is informed on a periodic basis, and in relevant detail, or has access to information concerning the classification of credits and assets and provisioning.
7. The supervisor has the power to require a bank to increase its levels of provisions and reserves and/or overall financial strength if it deems the level of problem assets to be of concern.
8. The supervisor assesses whether the classification of the credits and assets and the provisioning is adequate for prudential purposes. If provisions are deemed to be inadequate, the supervisor has the power to require additional provisions or to impose other remedial measures.
9. The supervisor requires banks to have appropriate mechanisms in place for periodically assessing the value of risk mitigants, including guarantees and collateral. The valuation of collateral is required to reflect the net realisable value.
10. Laws, regulations or the supervisor establish criteria for assets to be identified as impaired, eg loans are identified as impaired when there is reason to believe that all amounts due (including principal and interest) will not be collected in accordance with the contractual terms of the loan agreement.
11. The supervisor determines that the Board receives timely and appropriate information on the condition of the bank's asset portfolio, including classification of credits, the level of provisioning and major problem assets.
12. The supervisor requires that valuation, classification and provisioning for large exposures are conducted on an individual item basis.

#### ***Additional criterion***

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

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such external reviews, it is the supervisor that must be satisfied with a bank's classification and provisioning policies and processes.

<sup>22</sup> It is recognised that there are two different types of off-balance sheet transactions: those that can be unilaterally cancelled by the bank (based on contractual arrangements and therefore may not be subject to provisioning), and those that cannot be unilaterally cancelled.

## **Principle 10: Large exposure limits**

Supervisors must be satisfied that banks have policies and processes that enable management to identify and manage concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single counterparties or groups of connected counterparties.<sup>23</sup>

(Reference documents: *Measuring and controlling large credit exposures*, January 1991; and *Principles for managing credit risk*, September 2000.)

### **Essential criteria**

1. Laws or regulations explicitly define, or the supervisor has the power to define, a “group of connected counterparties” to reflect actual risk exposure. The supervisor may exercise discretion in applying this definition on a case by case basis.
2. Laws, regulations or the supervisor set prudent limits on large exposures to a single counterparty or a group of connected counterparties. “Exposures” include all claims and transactions, on-balance sheet as well as off-balance sheet. The supervisor confirms that senior management monitors these limits and that they are not exceeded on a solo or consolidated basis.
3. The supervisor determines that a bank’s management information systems identify and aggregate on a timely basis exposure to individual counterparties and groups of connected counterparties.
4. The supervisor confirms that a bank’s risk management policies and processes establish thresholds for acceptable concentrations of credit and require that all material concentrations be reviewed and reported periodically to the Board.
5. The supervisor regularly obtains information that enables concentrations within a bank’s portfolio, including sectoral, geographical and currency exposures, to be reviewed. The supervisor has the power to require banks to take remedial actions in cases where concentrations appear to present significant risks.

### **Additional criterion**

1. Banks are required to adhere to the following definitions:
  - ten per cent or more of a bank’s capital is defined as a large exposure; and
  - twenty-five per cent of a bank’s capital is the limit for an individual large exposure to a private sector non-bank counterparty or a group of connected counterparties.

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

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<sup>23</sup> Connected counterparties may be a group of companies related financially or by common ownership, management or any combination thereof.

## **Principle 11: Exposures to related parties**

In order to prevent abuses arising from exposures (both on-balance sheet and off-balance sheet) to related parties<sup>24</sup> and to address conflict of interest, supervisors must have in place requirements that banks extend exposures to related companies and individuals on an arm's length basis; these exposures are effectively monitored; appropriate steps are taken to control or mitigate the risks; and write-offs of such exposures are made according to standard policies and processes.

(Reference document: *Principles for the management of credit risk*, September 2000.)

### **Essential criteria**

1. Laws or regulations explicitly provide, or the supervisor has the power to provide, a comprehensive definition of "related parties". This should consider the parties identified in the footnote to the Principle. The supervisor may exercise discretion in applying this definition on a case by case basis.
2. Laws, regulations or the supervisor require that exposures to related parties may not be granted on more favourable terms (ie for credit assessment, tenor, interest rates, amortisation schedules, requirement for collateral) than corresponding exposures to non-related counterparties.<sup>25</sup>
3. The supervisor requires that transactions with related parties and the write-off of related-party exposures exceeding specified amounts or otherwise posing special risks are subject to prior approval by the bank's Board. The supervisor requires that Board members with conflicts of interest are excluded from the approval process.
4. The supervisor requires that banks have policies and processes in place to prevent persons benefiting from the exposure and/or persons related to such a person from being part of the process of granting and managing the exposure.
5. Laws or regulations set, or the supervisor has the power to set on a general or case by case basis, limits for exposures to related parties, to deduct such lending from capital when assessing capital adequacy, or to require collateralisation of such exposures.
6. The supervisor requires banks to have policies and processes to identify individual exposures to related parties as well as the total amount of such exposures, and to monitor and report on them through an independent credit review process. The supervisor confirms that exceptions to policies, processes and limits are reported to the appropriate level of senior management and, if necessary, to the Board, for timely action. The supervisor also confirms that senior management monitors related party transactions on an ongoing basis, and that the Board also provides oversight of these transactions.

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<sup>24</sup> Related parties can include the bank's subsidiaries and affiliates, and any party that the bank exerts control over or that exerts control over the bank. It may also include the bank's major shareholders, directors, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies.

<sup>25</sup> An exception may be appropriate for beneficial terms that are part of overall remuneration packages (eg staff receiving credit at favourable rates).

7. The supervisor obtains and reviews information on aggregate exposures to related parties.
8. Laws, regulations or the supervisor establish limits on aggregate exposures to related parties that are at least as strict as those for single counterparties, or groups of connected counterparties.

### **Principle 12: Country and transfer risks**

Supervisors must be satisfied that banks have adequate policies and processes for identifying, measuring, monitoring and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining adequate provisions and reserves against such risks.

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

#### ***Essential criteria***

1. The supervisor determines that a bank's policies and processes give due regard to the identification, measurement, 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 confirms that banks have information systems, risk management systems and internal control systems that accurately monitor and report country exposures and ensure adherence to established country exposure limits.
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 risk-based results. These include:
  - 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 and transfer risk of individual banks.

### **Principle 13: Market risk**

Supervisors must be satisfied that banks have in place policies and processes that accurately identify, measure, monitor and control market risks; supervisors should have

powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.

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

### **Essential criteria**

1. The supervisor determines that a bank has suitable policies and processes that clearly articulate roles and responsibilities related to the identification, measuring, monitoring and control of market risk. The supervisor is satisfied that policies and processes are adhered to in practice and are subject to appropriate Board and senior management oversight.
2. The supervisor determines that the bank has set market risk limits that are commensurate with the institution's size and complexity and that reflect all material market risks. Limits should be approved by the Board or senior management. The supervisor confirms that any limits (either internal or imposed by the supervisor) are adhered to.
3. The supervisor is satisfied that there are systems and controls in place to ensure that all transactions are captured on a timely basis, and that the banks' marked to market positions are revalued frequently, using reliable and prudent market data (or, in the absence of market prices, internal or industry-accepted models). The supervisor requires banks to establish and maintain policies and processes for considering valuation adjustments/reserves for positions that otherwise cannot be prudently valued, including concentrated, less liquid, and stale positions.
4. 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. The supervisor confirms that the approaches are integrated into risk management policies and processes, and results are taken into account in the bank's risk-taking strategy.

### **Additional criterion**

1. The supervisor requires that market data used to value trading book positions are verified by a function independent of the lines of business. To the extent that the bank relies on modelling for the purposes of valuation, the bank is required to ensure that the model is independently tested.

### **Principle 14: Liquidity risk**

Supervisors must be satisfied that banks have a liquidity management strategy that takes into account the risk profile of the institution, with prudent policies and processes to identify, measure, monitor and control liquidity risk, and to manage liquidity on a day to day basis. Supervisors require banks to have contingency plans for handling liquidity problems.

(Reference document: *Sound practices for managing liquidity in banking organisations*, February 2000.)

### ***Essential criteria***

1. The supervisor sets liquidity guidelines for banks and these take into consideration undrawn commitments and other off-balance sheet liabilities, as well as existing on-balance sheet liabilities.
2. The supervisor confirms that banks have a liquidity management strategy, as well as policies and processes for managing liquidity risk, which have been approved by the Board. The supervisor also confirms that the Board has an oversight role in ensuring that policies and processes for risk-taking are developed to monitor, control and limit liquidity risk, and that management effectively implements such policies and processes.
3. The supervisor determines that a bank's senior management has defined (or established) appropriate policies and processes to monitor, control and limit liquidity risk; implements effectively such policies and processes; and understands the nature and level of liquidity risk being taken by the bank.
4. The supervisor requires banks to establish policies and processes for the ongoing measurement and monitoring of net funding requirements. The policies and processes include considering how other risks (eg credit, market and operational risk) may impact the bank's overall liquidity strategy, and require an analysis of funding requirements under alternative scenarios, diversification of funding sources, a review of concentration limits, stress testing, and a frequent review of underlying assumptions to determine that they continue to be valid.
5. The supervisor obtains sufficient information to identify those institutions carrying out significant foreign currency liquidity transformation. Where a bank or banking group's foreign currency business, either directly, or indirectly through lending in foreign exchange to domestic borrowers, is significant, or where a particular currency in which the bank has material exposure is experiencing problems, the supervisor requires the bank to undertake separate analysis of its strategy for each currency individually and, where appropriate, set and regularly review limits on the size of its cash flow mismatches for foreign currencies in aggregate and for each significant individual currency.
6. The supervisor determines that banks have contingency plans in place for handling liquidity problems, including informing the supervisor.

### ***Additional criteria***

1. The supervisor determines that, where a bank conducts its business in multiple currencies, foreign currency liquidity strategy is separately stress-tested, and the results of such tests are a factor in determining the appropriateness of mismatches.
2. The supervisor confirms that banks periodically review their efforts to establish and maintain relationships with liability holders, maintain the diversification of liabilities, and aim to ensure their capacity to sell assets.

## **Principle 15: Operational risk**

Supervisors must be satisfied that banks have in place risk management policies and processes to identify, assess, monitor and mitigate operational risk.<sup>26</sup> These policies and processes are commensurate with the size and complexity of the bank.

(Reference documents: *Sound practices for the management and supervision of operational risk*, February 2003; and *Outsourcing in financial services*, Joint Forum, February 2005.)

### ***Essential criteria***

1. The supervisor requires individual banks to have in place risk management policies and processes to identify, assess, monitor and mitigate operational risk. These policies and processes are adequate for the size and complexity of the bank's operations, and the supervisor confirms that they are periodically adjusted in the light of the bank's changing risk profile and external market developments.
2. The supervisor requires that banks' strategies, policies and processes for the management of operational risk have been approved and are periodically reviewed by the Board. The supervisor also requires that the Board oversees management in ensuring that these policies and processes are implemented effectively.
3. The supervisor is satisfied that the approved strategy and significant policies and processes for operational risk are implemented effectively by management.
4. The supervisor reviews the quality and comprehensiveness of the bank's business resumption and contingency plans to satisfy itself that the bank is able to operate as a going concern and minimise losses, including those that may arise from disturbances to payment and settlement systems, in the event of severe business disruption.
5. The supervisor determines that banks have established appropriate information technology policies and processes that address areas such as information security and system development, and have made investments in information technology commensurate with the size and complexity of operations.
6. The supervisor requires that appropriate reporting mechanisms are in place to keep the supervisor apprised of developments affecting operational risk at banks in their jurisdictions.
7. The supervisor confirms that legal risk is incorporated into the operational risk management processes of the bank.
8. The supervisor determines that banks have established appropriate policies and processes to assess, manage and monitor outsourced activities. The outsourcing risk management programme should cover:
  - conducting appropriate due diligence for selecting potential service providers;
  - structuring the outsourcing arrangement;

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<sup>26</sup> The Basel Committee has defined operational risk as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The definition includes legal risk but excludes strategic and reputational risk.

- managing and monitoring the risks associated with the outsourcing arrangement;
- ensuring an effective control environment; and
- establishing viable contingency planning.

Outsourcing policies and processes should require the institution to have comprehensive contracts and/or service level agreements with a clear allocation of responsibilities between the outsourcing provider and the bank.

### ***Additional criterion***

1. The supervisor determines that the risk management policies and processes address the major aspects of operational risk, including an appropriate operational risk framework that is applied on a group-wide basis. The policies and processes should include additional risks prevalent in certain operationally intensive businesses, such as custody and correspondent banking, and should cover periods when operational risk could increase.

### **Principle 16: Interest rate risk**

Supervisors must be satisfied that banks have effective systems in place to identify, measure, monitor and control interest rate risk in the banking book, including a well defined strategy that has been approved by the Board and implemented by senior management; these should be appropriate to their size and complexity.

(Reference document: *Principles for the management and supervision of interest rate risk*, July 2004.)

### ***Essential criteria***

1. The supervisor determines that a bank's Board approves, and periodically reviews, the interest rate risk strategy and policies and processes for the identification, measuring, monitoring and control of interest rate risk. The supervisor also determines that management both implements the interest rate risk strategy and ensures that the above policies and processes are developed.
2. The supervisor determines that banks have in place comprehensive and appropriate interest rate risk measurement systems and that any models and assumptions are validated on a regular basis. It confirms that banks' limits reflect the risk strategy of the institution and are understood by and regularly communicated to relevant staff. The supervisor also confirms that exceptions to established policies, processes and limits should receive the prompt attention of senior management, and the Board where necessary.
3. The supervisor requires that banks periodically perform appropriate stress tests to measure their vulnerability to loss under adverse interest rate movements.

### ***Additional criteria***

1. The supervisor has the power to obtain from banks the results of their internal interest rate risk measurement systems, expressed in terms of the threat to



economic value, including using a standardised interest rate shock on the banking book.

2. The supervisor assesses whether the internal capital measurement systems of banks adequately capture the interest rate risk in the banking book.
3. The supervisor requires stress tests to be based on reasonable worst case scenarios and to capture all material sources of risk, including a breakdown of critical assumptions. Senior management is required to consider these results when establishing and reviewing a bank's policies, processes and limits for interest rate risk.
4. The supervisor requires banks to assign responsibility for interest rate risk management to individuals independent of and with reporting lines separate from those responsible for trading and/or other risk-taking activities. In the absence of an independent risk management function that covers interest rate risk, the supervisor requires the bank to ensure that there is a mechanism in place to mitigate a possible conflict of interest for managers with both risk management and risk-taking responsibilities.

#### **Principle 17: Internal control and audit**

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity 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 the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

(Reference documents: *Framework for internal control systems in banking organisations*, September 1998; *Internal audit in banks and the supervisor's relationship with auditors*, August 2001; and *Compliance and the compliance function in banks*, April 2005.)

#### **Essential criteria**

1. Laws, regulations or the supervisor establish the responsibilities of the Board and senior management with respect to corporate governance to ensure that there is effective control over a bank's entire business.
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 and/or senior management and deal with organisational structure, accounting policies and processes, checks and balances, and the safeguarding of assets and investments. More specifically, these controls address:
  - Organisational structure: definitions of duties and responsibilities, including clear delegation of authority (for example, clear loan approval limits), decision-making policies and processes, separation of critical functions (for example, business origination, payments, reconciliation, risk management, accounting, audit and compliance).
  - Accounting policies and processes: reconciliation of accounts, control lists, information for management.

- Checks and balances (or “four eyes principle”): segregation of duties, cross-checking, dual control of assets, double signatures.
  - Safeguarding assets and investments: including physical control.
3. Laws, regulations or the supervisor place the responsibility for the control environment on the Board and senior management of the bank. The supervisor requires that the Board and senior management understand the underlying risks in their business and are committed to a strong control environment.
  4. The supervisor has the power to require changes in the composition of the Board and senior management to address any prudential concerns related to the satisfaction of these criteria.
  5. 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.
  6. The supervisor determines that banks have a permanent compliance function<sup>27</sup> that assists senior management in managing effectively the compliance risks faced by the bank. The compliance function must be independent of the business activities of the bank. The supervisor determines that the Board exercises oversight of the management of the compliance function.
  7. The supervisor determines that banks have an independent, permanent and effective internal audit function charged with (i) ensuring that policies and processes are complied with and (ii) reviewing whether the existing policies, processes and controls remain sufficient and appropriate for the bank’s business.<sup>28</sup>
  8. The supervisor determines that the internal audit function:
    - has sufficient resources, and staff that are suitably trained and have relevant experience to understand and evaluate the business they are auditing;
    - has appropriate independence, including reporting lines to the Board and status within the bank to ensure that senior management reacts to and acts upon its recommendations;
    - has full access to and communication with any member of staff as well as full access to records, files or data of the bank and its affiliates, whenever relevant to the performance of its duties;
    - employs a methodology that identifies the material risks run by the bank;
    - prepares an audit plan based on its own risk assessment and allocates its resources accordingly; and
    - has the authority to assess any outsourced functions.

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<sup>27</sup> The term “compliance function” does not necessarily denote an organisational unit. Compliance staff may reside in operating business units or local subsidiaries and report up to operating business line management or local management, provided such staff also have a reporting line through to the head of compliance.

<sup>28</sup> The term “internal audit function” does not necessarily denote an organisational unit. Some countries allow small banks to implement a system of independent reviews, eg conducted by external experts, of key internal controls as an alternative.

### **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 to include a number of experienced non-executive directors.
2. The supervisor requires the internal audit function to report to an audit committee, or an equivalent structure.
3. In those countries with a unicameral Board structure, the supervisor requires the audit committee to include experienced non-executive directors.
4. Laws or regulations provide, or the supervisor ensures, that banks must notify the supervisor as soon as they become aware of any material information which may negatively affect the fitness and propriety of a Board member or a member of the senior management.

### **Principle 18: Abuse of financial services**

Supervisors must be satisfied that banks have adequate policies and processes in place, including strict “know-your-customer” rules, that promote high ethical and professional standards in the financial sector and prevent the bank from being used, intentionally or unintentionally, for criminal activities.<sup>29</sup>

(Reference documents: *Prevention of criminal use of the banking system for the purpose of money-laundering*, December 1988; *Customer due diligence for banks*, October 2001; *Shell banks and booking offices*, January 2003; *Consolidated KYC risk management*, October 2004; *FATF 40 + IX*, 2003 and *FATF AML/CFT Methodology*, 2004, as updated.)

### **Essential criteria**

1. Laws or regulations clarify the duties, responsibilities and powers of the banking supervisor and other competent authorities, if any, related to the supervision of banks’ internal controls and enforcement of the relevant laws and regulations regarding criminal activities.
2. The supervisor must be satisfied that banks have in place adequate policies and processes that promote high ethical and professional standards and prevent the bank from being used, intentionally or unintentionally, for criminal activities. This includes the prevention and detection of criminal activity, and reporting of such suspected activities to the appropriate authorities.
3. In addition to reporting to the financial intelligence unit or other designated authorities, banks report to the banking supervisor suspicious activities and

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<sup>29</sup> The Committee is aware that, in some jurisdictions, other authorities, such as a financial intelligence unit (FIU), rather than a banking supervisor, may have primary responsibility for assessing compliance with laws and regulations regarding criminal activities in banks, such as fraud, money laundering and terrorist financing. Thus, in the context of this Principle, “the supervisor” might refer to such other authorities, in particular in ECs 6, 7 and 9. In such jurisdictions, the banking supervisor cooperates with such authorities to achieve adherence with the criteria mentioned in this CP.

incidents of fraud when they are material to the safety, soundness or reputation of the bank.<sup>30</sup>

4. The supervisor is satisfied that banks establish “know-your-customer” (KYC) policies and processes which are well documented and communicated to all relevant staff. Such policies and processes must also be integrated into the bank’s overall risk management. The KYC management programme, on a group-wide basis, has as its essential elements:
  - a customer acceptance policy that identifies business relationships that the bank will not accept;
  - a customer identification, verification and due diligence programme; this encompasses verification of beneficial ownership and includes risk-based reviews to ensure that records are updated and relevant;
  - policies and processes to monitor and recognise unusual or potentially suspicious transactions, particularly of high-risk accounts;
  - escalation to the senior management level of decisions on entering into business relationships with high-risk accounts, such as those for politically exposed persons, or maintaining such relationships when an existing relationship becomes high-risk; and
  - clear rules on what records must be kept on consumer identification and individual transactions and their retention period. Such records should have at least a five year retention period.
5. The supervisor is satisfied that banks have enhanced due diligence policies and processes regarding correspondent banking. Such policies and processes encompass:
  - gathering sufficient information about their respondent banks to understand fully the nature of their business and customer base, and how they are supervised; and
  - not establishing or continuing correspondent relationships with foreign banks that do not have adequate controls against criminal activities or that are not effectively supervised by the relevant authorities, or with those banks that are considered to be shell banks.
6. The supervisor periodically confirms that banks have sufficient controls and systems in place for preventing, identifying and reporting potential abuses of financial services, including money laundering.
7. The supervisor has adequate enforcement powers (regulatory and/or criminal prosecution) to take action against a bank that does not comply with its obligations related to criminal activities.
8. The supervisor must be satisfied that banks have:

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<sup>30</sup> Consistent with international standards, banks are to report suspicious activities involving cases of potential money laundering and terrorist financing to the relevant national centre, established either as an independent governmental authority or within an existing authority or authorities, that serves as an FIU.

- requirements for internal audit and/or external experts<sup>31</sup> to independently evaluate the relevant risk management policies, processes and controls. The supervisor must have access to their reports;
  - established policies and processes to designate compliance officers at the management level, and appointed a relevant dedicated officer to whom potential abuses of the bank's financial services (including suspicious transactions) shall be reported;
  - adequate screening policies and processes to ensure high ethical and professional standards when hiring staff; and
  - ongoing training programmes for their staff on KYC and methods to detect criminal and suspicious activities.
- 9 The supervisor determines that banks have clear policies and processes for staff to report any problems related to the abuse of the banks' financial services to either local management or the relevant dedicated officer or to both. The supervisor also confirms that banks have adequate management information systems to provide managers and the dedicated officers with timely information on such activities.
10. Laws and regulations ensure that a member of a bank's staff who reports suspicious activity in good faith either internally or directly to the relevant authority cannot be held liable.
11. The supervisor is able to inform the financial intelligence unit and, if applicable, other designated authority of any suspicious transactions. In addition, it is able, directly or indirectly, to share with relevant judicial authorities information related to suspected or actual criminal activities.
12. The supervisor is able, directly or indirectly, to cooperate with the relevant domestic and foreign financial sector supervisory authorities or share with them information related to suspected or actual criminal activities where this information is for supervisory purposes.

#### ***Additional criterion***

1. If not done by another authority, the supervisor has in-house resources with specialist expertise for addressing criminal activities.

#### **Principle 19: Supervisory approach**

An effective banking supervisory system requires that supervisors develop and maintain a thorough understanding of the operations of individual banks and banking groups, and also of the banking system as a whole, focusing on safety and soundness, and the stability of the banking system.

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<sup>31</sup> May be external auditors or other qualified parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

### ***Essential criteria***

1. The supervisor has policies and processes in place to develop and maintain a thorough understanding of the risk profile of individual banks and banking groups.
2. The supervisor monitors and assesses trends, developments and risks for the banking system as a whole. The supervisor also takes into account developments in non-bank financial institutions through frequent contact with their regulators.
3. The supervisor uses a methodology for determining and assessing on an ongoing basis the nature, importance and scope of the risks to which individual banks or banking groups are exposed. The methodology should cover, inter alia, the business focus, the risk profile and the internal control environment, and should permit relevant comparisons between banks. Supervisory work is prioritised based on the results of these assessments.<sup>32</sup>
4. The supervisor confirms banks' and banking groups' compliance with prudential regulations and other legal requirements.
5. The supervisor requires banks to notify it of any substantive changes in their activities, structure and overall condition, or as soon as they become aware of any material adverse developments, including breach of legal or prudential requirements.
6. The supervisor has an adequate information system which facilitates the processing, monitoring and analysis of prudential information. The system aids the identification of areas requiring follow-up action.

### ***Additional criterion***

1. The supervisor employs a well defined methodology designed to establish a forward-looking view on the risk profile of banks, positioning the supervisor better to address proactively any serious threat to the stability of the banking system from any current or emerging risks.

## **Principle 20: Supervisory techniques**

An effective banking supervisory system should consist of on-site and off-site supervision and regular contacts with bank management.

### ***Essential criteria***

1. The supervisor employs an appropriate mix of on-site and off-site supervision to evaluate the condition of banks, their inherent risks, and the corrective measures necessary to address supervisory concerns. The specific mix may be determined by the particular conditions and circumstances of the country. The supervisor has policies and processes in place to assess the quality, effectiveness and integration of on-site and off-site functions, and to address any weaknesses that are identified.

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<sup>32</sup> Please refer to the footnote to CP 1(1), AC 1.

2. The supervisor has in place a coherent process for planning and executing on-site and off-site activities. There are policies and processes in place to ensure that such activities are conducted on a thorough and consistent basis with clear responsibilities, objectives and outputs, and that there is effective coordination and information sharing between the on-site and off-site functions.
3. On-site work, conducted either by the supervisor's own staff or through the work of external experts,<sup>33</sup> is used as a 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;<sup>34</sup>
  - obtain additional information on the bank and its related companies needed for the assessment of the condition of the bank, the evaluation of material risks, and the identification of necessary remedial actions and supervisory actions, including enhanced off-site monitoring; and
  - monitor the bank's follow-up on supervisory concerns.
4. Off-site work is used as a tool to:
  - regularly review and analyse the financial condition of individual banks using prudential reports, statistical returns and other appropriate information, including publicly available information;
  - follow up on matters requiring further attention, evaluate developing risks and help identify the priorities and scope of further work; and
  - help determine the priorities and scope of on-site work.
5. Based on the risk profile of individual banks, the supervisor maintains sufficiently frequent contacts as appropriate with the bank's Board, non-executive directors, Audit Committee and senior and middle management (including heads of individual business units and control functions) to develop an understanding of and assess such matters as strategy, group structure, corporate governance, performance, capital adequacy, liquidity, asset quality and risk management systems.
6. On an ongoing basis during on-site and off-site supervisory activities, the supervisor considers the quality of the Board and management.
7. The supervisor evaluates the work of the bank's internal audit function, and determines whether, and to what extent, it may rely on the internal auditors' work to identify areas of potential risk.
8. The supervisor communicates to the bank the findings of its on- and off-site supervisory analyses by means of written reports or through discussions or meetings with management.

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<sup>33</sup> May be external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

<sup>34</sup> Please refer to CP 21.

### ***Additional criterion***

1. The supervisor meets periodically with senior management and the Board to discuss the results of supervisory examinations and the external audit. The supervisor should also meet separately with the independent Board members, as necessary.

### **Principle 21: Supervisory reporting**

Supervisors must have a means of collecting, reviewing and analysing prudential reports and statistical returns from banks on both a solo and a consolidated basis, and a means of independent verification of these reports, through either on-site examinations or use of external experts.<sup>35</sup>

### ***Essential criteria***

1. The supervisor has the power<sup>36</sup> to require banks to submit information, on both a solo and a consolidated basis, on their financial condition, performance, and risks, at regular intervals. These reports provide information on such matters as on- and off-balance sheet assets and liabilities, profit and loss, capital adequacy, liquidity, large exposures, asset concentrations (including by economic sector, geography and currency), asset quality, loan loss provisioning, related party transactions, interest rate risk and market risk.
2. The supervisor provides report instructions that clearly describe the accounting standards to be used in preparing supervisory reports. Such standards are based on accounting principles and rules that are widely accepted internationally.
3. The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant.
4. The supervisor collects and analyses information from banks at a frequency (eg monthly, quarterly and annually) commensurate with the nature of the information requested, and the size, activities and risk profile of the individual bank.
5. In order to make meaningful comparisons between banks and banking groups, the supervisor collects data from all banks and all relevant entities covered by consolidated supervision on a comparable basis and related to the same dates (stock data) and periods (flow data).
6. The supervisor has the power 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 banking group, or to the assessment of the risks of the bank or banking group. This includes internal management information.

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<sup>35</sup> In the context of this CP, “prudential reports and statistical returns” are distinct from and in addition to required accounting reports. The former are addressed by this CP, and the latter are addressed in CP 22.

<sup>36</sup> Please refer to CP 1(3).



7. The supervisor has the power of full access<sup>37</sup> to all bank records for the furtherance of supervisory work. The supervisor also has similar access to the bank's Board, management and staff, when required.
8. The supervisor has a means of enforcing compliance with the requirement 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 misreporting and persistent errors, and can require that inaccurate information be amended.
9. The supervisor utilises policies and processes to confirm the validity and integrity of supervisory information. This includes a programme for the periodic verification of supervisory returns by means either of the supervisor's own staff or of external experts.<sup>38</sup>
10. The supervisor clearly defines and documents the roles and responsibilities of external experts,<sup>39</sup> including the scope of the work, when they are appointed to conduct supervisory tasks and monitors the quality of the work. External experts may be utilised for routine validation or to examine specific aspects of banks' operations.
11. The supervisor requires that external experts bring to its attention promptly any material shortcomings identified during the course of any work undertaken by them for supervisory purposes.

## **Principle 22: Accounting and disclosure**

Supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with accounting policies and practices that are widely accepted internationally, and publishes, on a regular basis, information that fairly reflects its financial condition and profitability.

(Reference document: *Enhancing bank transparency*, September 1998.)

### ***Essential criteria***

1. The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that financial record-keeping systems and the data they produce are reliable.
2. The supervisor has the power to hold bank management and the bank's Board responsible for ensuring that the financial statements issued annually to the public receive proper external verification and bear an external auditor's opinion.

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<sup>37</sup> Please refer to CP 1(4).

<sup>38</sup> May be external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions.

<sup>39</sup> May be external auditors or other qualified external parties, commissioned with an appropriate mandate, and subject to appropriate confidentiality restrictions. External experts may conduct reviews used by the supervisor, yet it is ultimately the supervisor that must be comfortable with the results of the reviews conducted by such external experts.

3. The supervisor requires banks to utilise valuation rules that are consistent, realistic and prudent, taking account of current values where relevant, and to show profits net of appropriate provisions.
4. Laws or regulations set, or the supervisor has the power, in appropriate circumstances, to establish, the scope of external audits of individual banks and the standards to be followed in such audits.
5. Supervisory guidelines or local auditing standards determine 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.
6. The supervisor has the power to reject the appointment of an external auditor that is deemed to have inadequate expertise or independence, or found not to be subject to or not to follow established professional standards.
7. The supervisor requires banks to produce annual audited financial statements based on accounting principles and rules that are widely accepted internationally and have been audited in accordance with internationally accepted auditing practices and standards.
8. Laws, regulations or the supervisor<sup>40</sup> require periodic public disclosures of information by banks that adequately reflect the bank's true financial condition. The requirements imposed should promote the comparability, relevance, reliability and timeliness of the information disclosed.
9. The required disclosures include both qualitative and quantitative information on a bank's financial performance, financial position, risk management strategies and practices, risk exposures, transactions with related parties, accounting policies, and basic business, management and governance. The scope and content of information provided and the level of disaggregation and detail should be commensurate with the size and complexity of a bank's operations.
10. Laws, regulations or the supervisor provide effective review and enforcement mechanisms designed to confirm compliance with disclosure standards.
11. The supervisor or other relevant bodies publish aggregate information on the banking system to facilitate public understanding of the banking system and the exercise of market discipline. Such information includes aggregate data on balance sheet indicators and statistical parameters that reflect the principal aspects of banks' operations (balance sheet structure, capital ratios, income earning capacity, and risk profiles).

### ***Additional criteria***

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

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<sup>40</sup> For the purposes of this EC, the disclosure requirement may be found in applicable accounting, stock exchange listing, or other similar rules, instead of or in addition to directives issued by the supervisor.

2. External auditors, whether or not utilised by the supervisor for supervisory purposes, have the 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, or other matters which they believe are likely to be of material significance to the functions of the supervisor. Laws or regulations ensure that auditors who make any such reports in good faith cannot be held liable for breach of a duty of confidentiality.
3. Laws, regulations or the supervisor require banks to rotate their external auditors (either the firm or individuals within the firm) from time to time.
4. The supervisor requires banks to have a formal disclosure policy.
5. The supervisor has the power to access external auditors' working papers, where necessary.

### **Principle 23: Corrective and remedial powers of supervisors**

Supervisors must have at their disposal an adequate range of supervisory tools to bring about timely corrective actions. This includes the ability, where appropriate, to revoke the banking licence or to recommend its revocation.

#### ***Essential criteria***

1. The supervisor raises supervisory concerns with management or, where appropriate, the Board, at an early stage, and requires that these concerns are addressed in a timely manner. Where the supervisor requires the bank to take significant remedial actions, these are addressed in a written document to the Board. The supervisor requires the bank to submit regular written progress reports and checks that remedial actions are completed satisfactorily.
2. 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).
3. The supervisor has available<sup>41</sup> an appropriate range of supervisory tools for use when, in the supervisor's judgment, a bank is not complying with laws, regulations or supervisory decisions, or is engaged in unsafe or unsound practices, or where the interests of depositors are otherwise threatened. These tools include the ability to require a bank to take prompt remedial action and to impose penalties. In practice, the range of tools is applied in accordance with the gravity of a situation.
4. The supervisor has available a broad range of possible measures to address such scenarios as described in EC 3 above and provides clear prudential objectives or sets out the actions to be taken, which may include 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, Board directors or controlling owners, facilitating a takeover by or merger

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<sup>41</sup> Please refer to CP 1(4).

with a healthier institution, providing for the interim management of the bank, and revoking or recommending the revocation of the banking licence.

5. The supervisor has the power to take measures should a bank fall below the minimum capital ratio, and seeks to intervene at an early stage to prevent capital from falling below the minimum. The supervisor has a range of options to address such scenarios.
6. The supervisor applies penalties and sanctions not only to the bank but, when and if necessary, also to management and/or the Board, or individuals therein.

#### **Additional criteria**

1. Laws or regulations mitigate against the supervisor unduly delaying appropriate corrective actions.
2. The supervisor has the power to take remedial actions, including ring-fencing of the bank from the actions of parent companies, subsidiaries and other related companies in matters that could impair the safety and soundness of the bank.
3. When taking formal remedial action in relation to a bank, the supervisor ensures that the regulators of non-bank related financial entities are aware of its actions and, where appropriate, coordinates its actions with them.

#### **Principle 24: Consolidated supervision**

An essential element of banking supervision is that supervisors supervise the banking group on a consolidated basis, adequately monitoring and, as appropriate, applying prudential norms to all aspects of the business conducted by the group worldwide.<sup>42</sup>

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

#### **Essential criteria**

1. The supervisor is familiar with the overall structure of banking groups and has an understanding of the activities of all material parts of these groups, domestic and cross-border.
2. The supervisor has the power to review the overall activities of a banking group, both domestic and cross-border. The supervisor has the power to supervise the foreign activities of locally incorporated banks.

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<sup>42</sup> For the purposes of consolidated supervision according to CP 24, a banking group includes the bank and its offices, subsidiaries, affiliates and joint ventures, both domestic and foreign. Other entities, for example parent companies and non-bank (including non-financial) group entities, may also be relevant. This group-wide approach to supervision, whereby all risks run by a banking group are taken into account, wherever they are booked, may go beyond accounting consolidation.

3. 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.
4. The supervisor has the power to impose prudential standards on a consolidated basis for the banking group. The supervisor uses its power to establish prudential standards on a consolidated basis to cover such areas as capital adequacy, large exposures and lending limits. The supervisor collects consolidated financial information for each banking group.
5. The supervisor has arrangements with other relevant supervisors, domestic and cross-border, to receive information on the financial condition and adequacy of risk management and controls of the different entities of the banking group.
6. The supervisor has the power to limit the range of activities the consolidated group may conduct and the locations in which activities can be conducted; the supervisor uses this power to determine that the activities are properly supervised and that the safety and soundness of the bank are not compromised.
7. The supervisor determines that management is maintaining proper oversight of the bank's foreign operations, including branches, joint ventures and subsidiaries. The supervisor also determines that banks' policies and processes ensure that the local management of any cross-border operations has the necessary expertise to manage those operations in a safe and sound manner and in compliance with supervisory and regulatory requirements.
8. The supervisor determines that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) includes: (i) information reporting on its foreign operations that is adequate in scope and frequency to manage their overall risk profile and is periodically verified; (ii) assessing in an appropriate manner compliance with internal controls; and (iii) ensuring effective local oversight of foreign operations.

For the purposes of consolidated risk management and supervision, there should be no hindrance in host countries for the parent bank to have access to all the material information from their foreign branches and subsidiaries. Transmission of such information is on the understanding that the parent bank itself undertakes to maintain the confidentiality of the data submitted and to make them available only to the parent supervisory authority.

9. The home supervisor has the power to require the closing of foreign offices, or to impose limitations on their activities, if:
  - it determines that oversight by the bank and/or supervision by the host supervisor is not adequate relative to the risks the office presents; and/or
  - it cannot gain access to the information required for the exercise of supervision on a consolidated basis.
10. The supervisor confirms that oversight of a bank's foreign operations by management (of the parent bank or head office and, where relevant, the holding company) is particularly close when the foreign activities have a higher risk profile or when the operations are conducted in jurisdictions or under supervisory regimes differing fundamentally from those of the bank's home country.

### **Additional criteria**

1. For those countries that allow corporate ownership of banking companies:
  - the supervisor has the power to review the activities of parent companies and of companies affiliated with the parent companies, and uses the power in practice to determine the safety and soundness of the bank; and
  - the supervisor has the power to establish and enforce fit and proper standards for owners and senior management of parent companies.
2. The home supervisor assesses the quality of supervision conducted in the countries in which its banks have material operations.
3. The supervisor arranges to visit the foreign locations periodically, the frequency being determined by the size and risk profile of the foreign operation. The supervisor meets the host supervisors during these visits. The supervisor has a policy for assessing whether it needs to conduct on-site examinations of a bank's foreign operations, or require additional reporting, and has the power and resources to take those steps as and when appropriate.

### **Principle 25: Home-host relationships**

Cross-border consolidated supervision requires cooperation and information exchange<sup>43</sup> between home supervisors and the various other supervisors involved, primarily host banking supervisors. Banking supervisors must require the local operations of foreign banks to be conducted to the same standards required of domestic institutions.

(Reference documents: *Principles for the supervision of banks' foreign establishments (Concordat)*, May 1983; *Report on Cross-Border Banking Supervision*, June 1996; *Shell banks and booking offices*, January 2003; and *The high-level principles for the cross-border implementation of the New Accord*, August 2003.)

### **Essential criteria**

1. Information to be exchanged by home and host supervisors should be adequate for their respective roles and responsibilities.
2. For material cross-border operations of its banks, the supervisor identifies all other relevant supervisors and establishes informal or formal arrangements (such as memoranda of understanding) for appropriate information sharing, on a confidential basis, on the financial condition and performance of such operations in the home or host country. Where formal cooperation arrangements are agreed, their existence should be communicated to the banks and banking groups affected.
3. The home supervisor provides information to host supervisors, on a timely basis, concerning:
  - the specific operations in the host country;
  - the overall framework of supervision in which the banking group operates;

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<sup>43</sup> Information exchange is covered in more detail in CP 1(6), which underpins the standards set out in this CP.

- the bank or banking group, to allow a proper perspective of the activities conducted within the host country's borders; and
- where possible and appropriate, significant problems arising in the head office or the banking group as a whole, where they may have a material effect on the foreign subsidiary or branch.

A minimum level of information on the bank or banking group will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of a bank's or banking group's activities to the financial sector of the host country. In this context, the host supervisor will inform the home supervisor when a local operation is material to the financial sector of the host country.

4. The host supervisor provides information to home supervisors, on a timely basis, concerning:
  - material or persistent non-compliance with relevant supervisory requirements, such as capital ratios or operational limits, specifically applied to a bank's operations in the host country;
  - adverse or potentially adverse developments in the local operations of a bank or banking group regulated by the home supervisor;
  - adverse assessments of such qualitative aspects of a bank's operations as risk management and controls at the offices in the host country; and
  - any material remedial action it takes regarding the operations of a bank regulated by the home supervisor.

A minimum level of information on the bank or banking group will be needed in most circumstances, but the overall frequency and scope of this information will vary depending on the materiality of the cross-border operations to the bank or banking group and financial sector of the home country. In this context, the home supervisor will inform the host supervisor when the cross-border operation is material to the bank or banking group and financial sector of the home country.

5. A host supervisor's national laws or regulations require that the cross-border operations of foreign banks are subject to prudential, inspection and regulatory reporting requirements similar to those for domestic banks.
6. Before issuing a licence, the host supervisor establishes that no objection from the home supervisor has been received. For purposes of the licensing process, as well as ongoing supervision of cross-border banking operations in its country, the host supervisor assesses whether the home supervisor practises global consolidated supervision.
7. Home country supervisors are given on-site access to local offices and subsidiaries of a banking group in order to facilitate their assessment of the group's safety and soundness and compliance with KYC requirements. Home supervisors should inform host supervisors of intended visits to local offices and subsidiaries of banking groups.

8. The host supervisor supervises shell banks,<sup>44</sup> where they still exist, and booking offices in a manner consistent with internationally agreed standards.
9. A supervisor that takes consequential action on the basis of information received from another supervisor consults with that supervisor, to the extent possible, before taking such action.

***Additional criterion***

1. Where necessary, the home supervisor develops an agreed communication strategy with the relevant host supervisors. The scope and nature of the strategy should reflect the size and complexity of the cross-border operations of the bank or banking group.

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<sup>44</sup> Reference document: *BCBS paper on shell banks*; 2003. See also footnote on CP3 EC5.



DRAFT – September 22, 2005

## ANNEX

### **Structure and methodology for assessment reports prepared by the International Monetary Fund and the World Bank**

This Annex presents guidance and a format for the organization and methodology of the assessment reports recommended by the IMF and the World Bank for use by assessors in the context of Financial Sector Assessment Program (FSAP) or Offshore Financial Center Program (OFC) missions. In order to maintain comparability and consistency, this format is also recommended when a standalone assessment or a self-assessment is conducted by a country. The BCP assessment report should be divided into eight parts: (1) a general section providing background information; (2) the methodology used; (3) an overview of institutional and macroeconomic conditions and market infrastructure; (4) an analysis of preconditions for effective banking supervision; (5) detailed Principle-by-Principle assessment; (6) a compliance table summarizing the results of the assessment; (7) a recommended action plan; and (8) authorities' response.

The following paragraphs provide a brief description of each of the eight parts.

- 1. A general section which provides background information on the assessment conducted, i.e., describes the organization being assessed and the context in which the assessment is being conducted.** This section should indicate that the methodology of the assessment has been selected with the authorities' agreement, mentioning in particular whether the authorities agreed to be assessed on the basis of only the essential criteria or also agreed to use additional criteria for the assessment. The names and qualifications of the assessors should be mentioned in this section.
- 2. A section on the information and methodology used for the assessment.** This section should mention any self-assessments conducted by the authorities prior to the FSAP or at the request of the FSAP team, and questionnaires filled out by the authorities in preparation for the FSAP. It should also mention relevant laws, regulations and instructions, other documentation such as reports, studies, public statements, websites, unpublished guidelines, directives and assessments. This section should identify counterparty authorities and mention, in a generic way, senior officials<sup>45</sup> with whom interviews were held; and meetings with other domestic supervisory authorities, private sector spokespersons, other relevant government authorities or industry associations (such as bankers' associations, auditors and accountants). This section should mention factors that impeded or facilitated the assessment. In particular, information gaps should be mentioned, and an indication given of the extent to which these gaps may have affected the assessment.<sup>46</sup>
- 3. Overview of the institutional and macroeconomic setting and market structure.** This section should provide a general macroeconomic background relevant to the financial sector, describe

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<sup>45</sup> Names are typically avoided, in order to protect individuals and encourage candor.

<sup>46</sup> If the lack of information adversely impacts the quality and depth of the assessment of a particular Principle, assessors should refer to this in the comment section of the assessment template, and document the obstacles encountered, in particular where access to in-depth information is crucial in evaluating compliance. Such issues should be brought to the attention of the mission leaders and when necessary referred to headquarters staff for guidance.

the structure of the financial markets and, in particular, the banking sector, mentioning the number of banks, total assets to GDP, basic assessment of the stability, capital adequacy, profitability and risk profile of the sector, and information on ownership, i.e., foreign versus domestic, state-owned versus privately-owned, and similar information. Furthermore, it should provide an overview of the supervisory environment (e.g., the mandate, role and functions of the local regulatory authority, the role of self-regulatory organizations, oversight and regulatory arrangements, legal and institutional framework, transparency, public disclosure, and accountability practices). It should also summarize the capacity, competence, internal controls, integrity of operations, and operational autonomy of the supervisory function.

4. **Review of the preconditions for effective banking supervision.** This section should provide an overview of the preconditions for effective banking supervision, as described in the Basel Core Principles document:

- *soundness and sustainability of macroeconomic policies (those aspects that could affect the structure and performance of the banking industry);*
- *a well developed public infrastructure;*
- *effective market discipline; and*
- *mechanisms for providing an appropriate level of systemic protection (or public safety net).*

Assessors should pay close attention to the adequacy of regulatory preconditions. This section requires a succinct and well structured factual review of preconditions, as experience has shown that insufficient implementation of the preconditions can seriously undermine the quality and effectiveness of banking supervision. It is important that the reader of the assessment report is able to properly interpret the gradings of the individual Principles in light of the way in which the preconditions are met. The review of the preconditions should strictly follow the headings indicated above, and provide the necessary factual information to give a clear view to the reader of the assessment of the Core Principles. The assessment of compliance with individual CPs could flag the CPs which are likely to be primarily affected by preconditions considered to be weak. However, standards assessors should not undertake to assess preconditions themselves, as this is beyond the scope of the individual standard assessments as established by the Boards of the IMF and the World Bank. The review normally should take up no more than one or two paragraphs for each type of precondition.

In particular with regard to the presence of sound and sustainable macroeconomic policies, the review of the preconditions should be descriptive, and should not express an opinion on the adequacy of policies in these areas, other than through reference to analyses and recommendations in existing IMF and World Bank documents, such as Article IV and other Bank and Fund program-related reports.

Also with regard to other components of the preconditions, the reviewers should rely to the greatest extent possible on official Fund and Bank documents and seek to ensure that the description and possible recommendations are consistent with other Fund and Bank positions on these issues.

When relevant, the assessors should attempt to include in their analysis the linkages between these factors and the stability of the banking system.

A factual review of the public infrastructure should focus on elements relevant to the banking system and, where appropriate, be prepared in coordination with other specialists on the mission and the Fund / Bank country teams. This part of the review of the preconditions could cover issues such as the presence of a good credit culture, a system of business laws including corporate, bankruptcy, contract consumer protection and private property laws that is consistently enforced and provides a mechanism

for the fair resolution of disputes; the presence of well trained and reliable accounting, auditing and legal professions, an effective and reliable judiciary, and adequate financial sector regulation; and efficient payment, clearing and settlement systems.

A review of the effectiveness of market discipline could, for instance, cover issues such as the presence of rules on corporate governance, transparency and audited financial disclosure, appropriate incentive structures for the hiring and removal of managers and Board members, protection of shareholders' rights, adequate availability of market and consumer information (e.g., through rating agencies), disclosure of government influence in banks, tools for the exercise of market discipline such as mobility of deposits and other assets held in banks, adequate periodicity of interest rate and other price quotes, an effective framework for mergers, takeovers, and acquisition of equity interests, possibility of foreign entry into the markets and foreign-financed takeovers.

An overview of the appropriateness of safety nets or systemic protection could, for instance, include the following elements: an analysis of the functions of the various entities involved such as supervisory authorities, deposit insurer and central bank. This would be followed by a review of the existence of a well defined process for dealing with crisis situations such as the resolution of a failed financial institution. This would be combined with an analysis of the coordination of the roles of the various involved entities within this process. Additionally, in connection with the use of public funds (including central bank funds) a review of whether sufficient measures are in place to minimize moral hazard would be conducted. Also, the mechanisms to meet banks' temporary short-term liquidity needs, primarily through the interbank market, but also from other sources, would need to be described.

**5. A detailed Principle-by-Principle assessment, providing a “description” of the system with regard to a particular Principle, a grading or “assessment”, and a “comments” section.**

Core Principle 1 is effectively subdivided into six sub-principles. In the template, each of the sub-principles should be treated as a separate principle, also in the summary table of the assessments (see below). Also, a composite assessment for CP 1 should be provided by the assessors. In cases in which the authorities are preparing a self-assessment, or “expert-assisted” self-assessment, it would greatly facilitate the IFI assessment if the authorities' self-assessment or expert-assisted assessment could also be prepared according to a specific template, available through the websites of the IMF and the World Bank, and sent to the assessors in advance of the FSAP, OFC or standalone assessment. The authorities would preferably not provide gradings in their self-assessment, as this would be done by the assessors during FSAPs. The assessment format below is also available for use by countries which wish to perform a self-assessment, or “expert-assisted” self-assessment. The template for the detailed assessment is structured as follows:

<b>Principle (x)</b> (repeating verbatim the text of the Principle)	
<b>Description</b>	
<b>Assessment</b>	
<b>Comments</b>	
<b>Principle (y)</b>	
<b>Description</b>	
<b>Assessment</b>	
<b>Comments</b>	

**The “description” section** of the template should provide information on the practice as observed in the country/group of countries being assessed. It should cite the relevant laws and regulations. This should be done in such a way that the relevant law or regulation can be easily located, for instance by reference to URLs, official gazettes, and similar sources. Insofar as possible and relevant, the description should be structured as follows: (1) banking laws and supporting regulations; (2) prudential regulations, including prudential reports and public disclosure; (3) supervisory tools and instruments; (4) institutional capacity of the supervisory authority; and (5) evidence of implementation and/or enforcement or the lack of it.

The latter factor has gained considerably more importance as it has become clear that, without effective implementation of rules and regulations, even a well designed supervisory system will not be effective. Examples of practical implementation should be reviewed by the assessors, provided by the authorities, and mentioned in the report. For instance: how many times over the past years have the authorities applied corrective action? How frequently have banks been inspected on-site? How many licensing applications have been received, and how many have been accepted/turned down? Have asset quality reports been prepared by the inspectors, and how have the conclusions been communicated to senior bank and banking supervision management?

The description should also highlight when and why compliance of 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 the “description”, to clearly demonstrate the assessor’s attempts to adequately assess a Principle. If the lack of information relates to a specific criterion, this can also be mentioned.

**The “assessment” section** should contain only one line, stating whether the system is “compliant”, “largely compliant”, “materially non-compliant”, “non-compliant” or “not applicable” as described in the Core Principles Methodology.

**The “comments” section should be used to explain why a particular grading was given, in particular when a less than “compliant” grading was given.** This reasoning could be structured as follows: (i) reasons related to the state of the laws and regulations and their implementation; (ii) the state of the supervisory tools and instruments, for instance reporting formats, early warning systems and inspection manuals; (iii) the quality of practical implementation; (iv) the state of the institutional capacity of the supervisory authority; and (v) enforcement practices. In case of a less than “compliant” grading, this section can be used to highlight which measures would be needed to achieve full

compliance, or why, notwithstanding the system seems compliant based on laws, regulations and policies being in place, yet a less than “compliant” grading was given, perhaps due to weaknesses in procedures or implementation. When linkages between particular Principles are evident, or between preconditions and Principles, for instance between Principle 8 on credit risk review and Principle 6 on capital adequacy, the “comments” section should be used to warn the reader that, although the capital adequacy regulation and practices seem compliant, a “compliant” grading cannot be given. This may not be possible because of serious deficiencies in the implementation of Principle 8, which would lead to an overstatement of capital and unreliable capital adequacy ratios.

Similarly, when a “compliant” grading was given, but observance was demonstrated through different mechanisms by the country, this should be explained in the “comments” section.

Grading to a Principle should be given regardless of the level of development of a country. If certain Principles are graded less than “compliant” due to the level of development of the financial sector in a country, this can be explained in the “comments” section, adding for instance which actions are needed, and when, to achieve a higher level of compliance. This could also be included in the action plan (see below). Assessors should, on the other hand, not give credit in their assessment for good intentions of the regulator or supervisor to adopt future regulations or practices, although this can receive favorable mention in the “comments” section. This latter point would be applicable in the case where actions are in process that would result in a “compliant” rating, but have not yet been effected or implemented.

**6. A compliance table, summarizing the assessments, Principle by Principle.**

The template for the compliance table is as follows:

<b>Basel Core Principles Compliance: Summary Table</b>	
<b>Grading</b>	<b>Principles</b>
<b>Compliant</b>	Principles a, b, c
<b>Largely compliant</b>	Principles d, e, f
<b>Materially non-compliant</b>	Principles g, h, i
<b>Non-compliant</b>	Principles j, k, l
<b>Not applicable</b>	Principles m, n, o

**7. A “Recommended Action Plan” providing Principle-by-Principle recommendations for actions and measures to improve the regulatory and supervisory framework and practices.**

As preconditions are not part of the standards, the detailed standards assessments in the FSAP should not contain recommendations with regard to the preconditions. However, where effective implementation of standards is likely to be hampered by weaknesses in the preconditions, the assessor may usefully point this out, and general FSAP recommendations may address related issues that are within the scope of the FSAP exercise.

This section should list the suggested steps for improving compliance. Recommendations should be proposed in each case where deficiencies are assessed. The steps identified for action should be specific in nature. An explanation could also be provided as to how the recommended action would

lead to improving the level of compliance and strengthening of the supervisory framework. The institutional responsibility for each suggested action should also be clearly indicated in order to prevent overlap or confusion. Note that Principles should be presented only for those to which specific recommendations are being made. Recommendations can also be made with regard to deficiencies in compliance with the additional criteria.

The template for the “Recommended Action Plan” is as follows:

<b>Recommended Action Plan to Improve Compliance with the Basel Core Principles</b>	
<b>Reference Principle</b>	<b>Recommended Action</b>
Principle (x)	Description of deficiency (y); suggested introduction of regulation (a), supervisory practice (b)
Principle (y)	Description of deficiency (x); suggested introduction of regulation (c), supervisory practice (d)

8. **Authorities’ response to the assessment.**<sup>47</sup> The assessor should provide the supervisory authority or authorities being assessed an opportunity to respond to the assessment findings, which would include providing the authorities with a full written draft of the assessment, and any differences of opinion on the assessment results should be clearly identified and included in the report. The assessment should allow for greater dialogue, and therefore the assessment team should have had a number of discussions with the supervisors during the assessment process so that the assessment should also reflect the comments, concerns and factual corrections of the supervisors. The authority or authorities should also be requested to prepare a concise written response to the findings (“right of reply”). The assessment should not, however, become the object of negotiations, and assessors and authorities should be willing “to agree to disagree”, provided the authorities’ views are represented fairly and accurately.

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<sup>47</sup> If no such response is provided within a reasonable time frame, the assessors should note this explicitly and provide a brief summary of the authorities’ initial response provided during the discussion between the authorities and the assessors at the end of the assessment mission (“wrap-up meeting”).