Basel Committee
on Banking Supervision

# Report for the G7 Summit

May 2005

BANK FOR INTERNATIONAL SETTLEMENTS

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ISBN print: 92-9131-689-X
ISBN web: 92-9197-689-X

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## I. Executive summary

During the past year, the Basel Committee on Banking Supervision published its new framework for assessing bank capital adequacy, entitled the *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, commonly referred to as Basel II. The new capital framework will promote global financial stability by improved capital regulations that include more risk sensitive minimum capital requirements, the supervisory review process and market discipline. Much of the Committee's energies are now being devoted to the implementation of Basel II in the coming years.

The Committee has participated in the work of the international community to address weaknesses in the global financial system through its promotion of prudential supervisory standards and sound bank risk management practices. The Committee has coordinated its activities with other international bodies including the Financial Stability Forum, the International Accounting Standards Board, the International Monetary Fund, the World Bank, the International Association of Insurance Supervisors, the International Organization of Securities Commissions and the Financial Action Task Force.

This report, prepared for the Group of Seven (G7) Finance Ministers and Central Bank Governors, discusses the Committee's main efforts over the past year. In addition to the Basel II framework:

- *The Committee has been a strong supporter of the efforts of the international community to strengthen market foundations*. It has been an active participant in the advisory bodies of the International Accounting Standards Board (IASB) and of the International Auditing and Assurance Standards Board (IAASB), has been a key player in the establishment of the Public Interest Oversight Board of the International Federation of Accountants, and continues to assess and comment on key IASB and IAASB proposals, in particular IAS 39 on financial instruments.
- *The Committee has continued to provide guidance on risk management in the banking sector.* Papers published have included guidance on consolidated know-your-customer (KYC) risk management, the supervision of interest rate risk and the compliance function in banks.
- *The Committee has undertaken several projects designed to help strengthen the global banking system.* The Basel Core Principles for Effective Banking Supervision are currently being revised in close collaboration with the IMF, the World Bank and major emerging market supervisors. In addition, the Committee's guidance on corporate governance is currently being reviewed.
- *The Committee continues to work with supervisors worldwide to promote better banking supervision*, jointly sponsoring the 13th International Conference of Banking Supervisors with the Bank of Spain in September 2004 and already starting plans for the next Conference in Mexico in 2006.

Section II of this report discusses the Committee's revised Capital Framework and ongoing work to achieve a smooth implementation. The subsequent section focuses on the Committee's work in the area of accounting, auditing and compliance. Section IV looks at the Committee's other major initiatives over the past year, including providing guidance on issues related to sound risk management, while Section V simply lists the various policy papers released by the Committee over the past year.

# II. The Revised Basel Capital Framework

The Basel II Framework, published in June 2004, presents the outcome of the Committee's work over recent years to secure international convergence on revisions to regulations governing the capital adequacy of internationally active banks. It sets out the Framework for measuring capital adequacy and the minimum standard to be achieved. The national supervisory authorities represented on the Committee will propose them for adoption in their respective countries.

The Framework will be available for implementation as of 1 January 2007. However, the most advanced approaches will be available as of 1 January 2008.

The fundamental objective of the Committee's work has been to develop a framework that would further strengthen the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks. The Committee believes that the revised Framework will promote the adoption of stronger risk management practices by the banking industry, and views this as one of its major benefits. In developing the revised Framework, the Committee has sought to arrive at significantly more risk-sensitive capital requirements that are conceptually sound and at the same time pay due regard to particular features of the present supervisory and accounting systems in individual member countries.

The Framework consists of three pillars: calculation of the minimum capital requirements for credit risk and operational risk (Pillar 1); the supervisory review process (Pillar 2); and market discipline (Pillar 3). Some significant changes have been made to earlier published proposals following intensive consultation with a range of interested parties.

### Pillar 1 – Minimum capital requirements

#### *Credit risk*

The revised Framework provides three alternative approaches for credit risk measurement to allow banks and supervisors to choose an approach most appropriate for the level of sophistication of a bank's activities and internal controls. The third round of public consultation resulted in a number of modifications to the more advanced approaches.

Most importantly, the Committee decided to align regulatory capital with unexpected credit losses only, rather than with both unexpected and expected credit losses. This change will better reflect the industry's practices with regard to the allocation of capital and provisions against credit-related losses.

Other major changes related to credit risk that are reflected in the final text of Basel II include revisions to, and simplifications of, the treatment of securitisation exposures; revisions to the treatment of revolving retail exposures; and refinements to the recognition of credit risk mitigation techniques.

#### *Operational risk*

Given the degree of progress that leading institutions and industry associations have made in measuring and managing exposures to operational risk, the Committee has continued its efforts to identify sound practices and to provide guidance to banks and supervisors on how the Basel II treatment of operational risk should be applied. In response to discussions with supervisors and bankers on the application of Basel II's "advanced measurement approach" to operational risk within a globally active institution, the Committee published a set of *Principles for the Home-Host Recognition of AMA Operational Risk Capital* in January 2004. The Committee offered additional thoughts on these principles in an appendix to a press release dated 11 May 2004.

### Pillar 2 – Supervisory review process

The supervisory review process recognises the responsibility of bank management in developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile and control environment. Bank management continues to bear the responsibility for ensuring that the bank has adequate capital to support its risks beyond the core minimum requirement. Supervisors are expected to evaluate how well banks are assessing their capital needs relative to their risks and to intervene, where appropriate. This interaction is intended to foster an active dialogue between banks and supervisors such that when deficiencies are identified, prompt and decisive action can be taken to reduce risk or restore capital. The Committee issued clarifications on the implementation of Pillar 2 in a January 2004 press release, and the Committee's Accord Implementation Group is engaged in ongoing discussions aimed at enhancing more consistency in the application of Pillar 2.

### Pillar 3 – Market discipline

The purpose of Pillar 3 - market discipline - is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. In principle, banks' disclosure should be consistent with how senior management and the board of directors assess and manage the risks of the bank. Along these lines and based on public comments received in the course of the Committee's consultations, the Committee has streamlined considerably the disclosure requirements as set out in Pillar 3.

### Trading book

In releasing the Basel II Framework, the Committee re-iterated its intention to maintain its active dialogue with the industry to ensure that the new Framework keeps pace with, and can be applied to, ongoing developments in the financial services sector.

Since March 2004, the Committee has worked jointly with the International Organization of Securities Commissions (IOSCO) to consult with industry representatives and other supervisors on these matters and has identified the following five specific issues to be addressed:

- the treatment of counterparty credit risk for over-the-counter derivatives, repo-style and securities financing transactions; and the treatment of cross-product netting arrangements;
- the treatment of double-default effects for hedged transactions, in relation with trading book, but also banking book, exposures;
- the short-term maturity adjustment, in the internal ratings-based approach, for some trading book-related items;

- improvements to the current trading book regime, especially with respect to the treatment of specific risk; and
- the design of a specific capital treatment for unsettled and failed transactions.

The proposals to address these five issues were released in a consultative paper on 11 April with comments due by 27 May. The Committee expects to finalise the rules and incorporate them into the Basel II Framework during the summer.

### Implementation issues

With the release of the Basel II text, national authorities in Basel Committee member countries are now working to adopt the Basel II text through domestic rule-making and approval processes. Consistent implementation of the new Framework across borders through enhanced supervisory cooperation will become a critical and challenging task in the years ahead. To encourage collaboration and shared approaches, the Committee's Accord Implementation Group (AIG) serves as a forum on implementation matters.

One of the primary tools that the AIG has used to promote more effective cross-border implementation of Basel II is the development of "real case studies", which have in most instances transitioned into development of real implementation plans. The primary role of these case studies is to help home and host supervisors to develop experience in implementing the Framework on a practical, case-by-case basis. Home and host supervisors are exploring ways to more effectively communicate and cooperate in the context of specific banking organisations, with a view toward "learning by doing." Just as each banking organisation is unique, so too are the working arrangements among supervisors. Consistency will be best achieved not through a top-down exercise in developing detailed rules, but rather through practical work and sharing of experiences.

The Committee believes that it is important to share lessons learned from the case studies and practical implementation efforts. In that regard, the AIG has begun to share experiences with each other and to develop preliminary lessons learned in a draft paper. These preliminary lessons learned have been shared not only among Basel Committee member countries, but also with non-G10 supervisors who are actively participating in the case study work.

Similarly, supervisors will need to consider how to validate risk measurement approaches in a manner that reduces the burden associated with implementation and increases consistency in the application of Basel II's expectations across jurisdictions. The AIG has begun a dialogue on the topic of validation, considering actual cases, and is working to broaden these discussions with other supervisors. It is also studying Pillar 2 issues and considering principles and options for implementing Pillar 2 and has taken up important technical work on how banks should best estimate "economic downturn" LGDs, among other issues. In addition, the AIG has begun work on issues specifically related to operational risk.

The AIG discusses issues of mutual concern with supervisors outside of the Committee's membership through its contacts with regional associations as well as the Core Principles Liaison Group, whose membership consists of both member and non-member countries. Also, many national supervisors who are not represented in the Committee have already begun to evaluate the suitability of the new Framework for banks in their jurisdiction and plan for the transition to Basel II. In order to further this process, the Committee supports a Working Group largely comprised of supervisory authorities from non-member countries to assess the issues involved in implementing Basel II, to help them decide whether and when to implement Basel II, and to provide practical suggestions to supervisors for the transition to the new Framework. These issues and suggestions are addressed in a paper published in July 2004 entitled *Implementation of Basel II: Practical Considerations*.

## III. Accounting and auditing issues

### Accounting

Over the past year, the Basel Committee's accounting-related activities have been dominated by efforts to resolve differences of view on an appropriate form for the IASB's fair value option. The debate has centred on whether the option should be unfettered or include sufficient conditions to ensure that the use of fair value reporting through profit and loss is handled responsibly. This issue has required significant effort on the part of the Committee to assist in finding a suitable solution. A proposed compromise was approved by the IASB at its 19 April meeting.

The Committee has also taken an active interest in the IASB's project to enhance financial instrument disclosures. Through the Committee's engagement at several stages of the project, financial reporting transparency will include greatly enhanced disclosures of financial risks and related risk management practices, broadly similar to the principles and requirements under Pillar 3 of the Basel Framework.

The Committee has also obtained observer status on three key IASB advisory groups that will focus on next steps for financial instruments, insurance liabilities and performance reporting. These projects are core to the financial reporting model for regulated financial institutions and require proactive engagement to ensure that reporting developments with possible impact on financial stability are identified and resolved in an effective and timely manner.

### Auditing

The IAASB is committed to achieve its own "stable platform" of core auditing standards and has adopted an aggressive timetable designed to facilitate timely adoption within Europe and other jurisdictions intending to adopt IFRS in the near future. The Committee has provided extensive commentary on a number of these proposals and, through its representation on the IAASB's Consultative Advisory Group, on future priorities.

The Committee has been actively engaged over several years in the development of a Public Interest Oversight Board to oversee international standard setting activities undertaken by IFAC, including, but not limited to, the IAASB. The PIOB fills an important gap in global oversight of financial reporting integrity and is designed to enhance the transparency and accountability of the standard setting groups within its scope. As part of the group of founding regulators (that also includes IOSCO, IAIS, the FSF and the World Bank), the Committee will monitor and assess the PIOB's performance over the near term.

## IV. Other efforts to strengthen banking supervision

The Committee's objective of strengthening prudential supervisory standards across the world's banking systems and in both G10 and non-G10 countries is achieved through a range of activities. These include publishing policy papers, sponsoring and participating in conferences and training, and maintaining links with supervisors worldwide. This section highlights the Committee's particular efforts over the past year in developing guidance for dealing with interest rate risk, anti money laundering and counter terrorist financing, compliance as well as current work on updating existing guidance on general banking supervisory principles and corporate governance. In addition, it covers the Committee's attempts to enhance cooperation between banking supervisors.

### Management and supervision of interest rate risk

As part of its continued efforts to enhance risk management in banks, the Committee published *Principles for the Management and Supervision of Interest Rate Risk* in July 2004. Principles 1 to 13 in this paper are intended to be of general application for the management of interest rate risk, independent of whether the positions are part of the trading book or reflect banks' non-trading activities. They refer to an interest rate risk management process, which includes the development of a business strategy, the assumption of assets and liabilities in banking and trading activities, as well as a system of internal controls. In particular, they address the need for effective interest rate risk measurement, monitoring and control functions within the interest rate risk management process. Principles 14 and 15, on the other hand, specifically address the supervisory treatment of interest rate risk in the banking book.

The principles are based on practices currently used by many international banks, even though their specific application will depend to some extent on the complexity and range of activities undertaken by individual banks. Under the new capital framework, they form minimum standards expected of internationally active banks. The Committee believes that the principles set out here should be used in evaluating the adequacy and effectiveness of a bank's interest rate risk management, in assessing the extent of interest rate risk run by a bank in its banking book, and in developing the supervisory response to that risk.

### Consolidated KYC risk management

The Committee published *Consolidated KYC Risk Management* in October 2004. The paper's objective is to provide guidance to banking groups on how to implement an effective groupwide KYC risk management process. Banks with inadequate KYC risk management programmes may be subject to significant risks, especially legal and reputational risk. Sound KYC policies and procedures not only contribute to a bank's overall safety and soundness, they also protect the integrity of the banking system by reducing the likelihood of banks becoming vehicles for money laundering, terrorist financing and other unlawful activities.

Consolidated KYC Risk Management means an established centralised process for coordinating and promulgating policies and procedures on a groupwide basis, as well as robust arrangements for the sharing of information within the group. Policies and procedures should be designed not merely to comply strictly with all relevant laws and regulations, but more broadly to identify, monitor and mitigate reputational, operational, legal and concentration risks. It is essential, in conducting effective monitoring on a groupwide basis, that banks be free to pass information about their liabilities or assets under management, subject to adequate legal protection, back to their head offices or parent bank. Jurisdictions should facilitate consolidated KYC risk management by providing an appropriate legal framework which allows the cross-border sharing of information.

## Compliance

In response to a rapidly growing need for guidance in this area, the Committee developed a guidance paper on principles and sound practices for compliance within a regulated banking environment. This paper addresses only those compliance risks related to banking activities. Although it does not prescribe a particular organisational model, the paper promotes common objectives through defining compliance risk and exploring the roles and responsibilities of the board, senior management and, in particular, the head of compliance. As the focus is on achieving and maintaining an effective compliance function, the paper also stresses the importance of adopting structures, procedures and controls that are appropriate to the organisation and its particular risk profile. Following a thorough consultation process, this paper was published on 29 April 2005.

## Basel Core Principles for Effective Banking Supervision

The Committee has set in train a process to revise the *Basel Core Principles for Effective Banking Supervision* (Core Principles) first published in 1997 and its accompanying Methodology published in 1999. The Core Principles framework contributes to the overall strengthening of banking systems. Stronger banks lead to stronger financial systems and thus to enhanced financial stability. The Core Principles provide a comprehensive framework of minimum sound supervisory practices rather than a framework of best practices. Although the Core Principles are internationally accepted as the benchmark for sound supervisory practices, experience gained in field-testing the principles, especially in the financial sector assessment programmes (FSAPs), and new developments in banking supervision called for a Core Principles update. The IMF, the World Bank, as well as many supervisors from countries not represented on the Basel Committee are active participants in this project.

The Committee has agreed that the update does not call for a radical rewrite, but a modest revision of those areas where adjustments to the current framework are required. The Committee intends to consult extensively with interested parties and to make the review process fully interactive.

## Corporate governance

In recent years there have been a number of high-profile corporate governance breakdowns, some involving banks, which have resulted in heightened attention by national supervisors and legislators. The OECD issued revised guidance on corporate governance in 2004 and this has led the Committee to establish a working group to review its own guidance on corporate governance *Enhancing Corporate Governance for Banking Organisations* issued in September 1999.

The Working Group is reviewing the recently revised guidance on corporate governance from the OECD and considering the extent to which this guidance can and should be applied specifically to the banking sector. Consideration is also being given to any lessons that may be learned from recent corporate governance breakdowns, especially related to the activities of banking organisations, as well as supervisory and legislative responses to these failures. The Working Group is considering possible “know your structure” guidance on the corporate governance aspects of the structure of banking groups, both through the use of offshore financial centres and through on-shore special purpose vehicles and trusts. Finally, the Working Group will consult with industry participants, international financial institutions (e.g. the World Bank and International Monetary Fund), other interested organisations (e.g. the OECD), and banking supervisors from non-Committee member countries, to solicit a range of views on bank corporate governance.

### Discussion, information sharing and cooperation among banking supervisors

The Committee continues to serve as the main forum for central banks and supervisory authorities to discuss and share information on banking supervisory issues. A variety of important topics are discussed and studied by the Committee and its various working groups and although many of the topics that are covered do not lead directly to formal papers, they are still valuable in informing the understanding of both the Committee and national supervisors in key areas.

Emphasis on collaboration means that member agencies can forge strong working relationships both at the senior and staff levels. The Committee is a keen supporter of research on banking and finance, and regularly sponsors events for researchers to share and discuss their latest work. These include workshops organised for researchers in central banks and supervisory agencies across the international community, such as one held in Vienna in April 2005. Other events have been aimed at promoting links between researchers in central banks/supervisory agencies and those in the wider academic community, such as the workshop held in Basel in May 2004.

The Committee values and continues to enhance its links with non-member groups of supervisors. The Core Principles Liaison Group (CPLG) brings together supervisors from G10 and non-G10 countries, the IMF and World Bank for discussions on the work of the Basel Committee and the range of international initiatives of interest to banking supervisors. In particular, the CPLG plays a key role in supporting the implementation of the Committee's *Core Principles for Effective Banking Supervision.* The Committee also continues to support the many regional groups of supervisors through participation in their annual meetings and through meetings with regional group representatives.

The International Conference of Banking Supervisors (ICBS) is the Committee's highly valued forum for promoting discussion and information sharing among senior supervisors on a global basis. In September 2004, the 13th ICBS was held in Madrid. Approximately 300 senior banking supervisors from well over 100 countries attended the event, which was jointly sponsored by the Basel Committee and the Bank of Spain. The ICBS, which takes place every second year, is designed to promote cooperation among national authorities in the supervision of international banking. The Madrid event allowed representatives from supervisory authorities of G10 and non-G10 countries to exchange views on the implementation of the Basel II capital framework, and on the accounting regime and banking supervision. The next ICBS will be held in Mexico in October 2006.

### Joint Forum

The Joint Forum was established in 1996 under the aegis of the BCBS, IOSCO, and the IAIS to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.

Key initiatives completed by the Joint Forum in the past year include a report entitled *Financial Disclosure in the Banking, Insurance and Securities Sectors: Issues and Analysis.* Published in May 2004, the report examines the progress made by financial firms in adopting the recommendations contained in the April 2001 report of the Multidisciplinary Working Group on Enhanced Disclosure (the Fisher II working group, a working group that was sponsored by the BCBS, CGFS, IAIS and IOSCO) and the efforts of regulators and other standard setters in the area of financial disclosure.

In February 2005, the Joint Forum published a report examining trends in outsourcing in the financial sector. *Outsourcing in Financial Services* spells out the potential risks that outsourcing activities can pose to financial sector firms, while recognising the substantial benefits that outsourcing can provide. The report lays out a set of principles addressing the issues that should be taken into account by firms in the management of their outsourcing activities and by supervisors in their assessment of those activities in the course of their supervisory work.

In March 2005, the Joint Forum released the final version of its paper on credit risk transfer (CRT) activity. The report, which was developed in response to a request from the Financial Stability Forum, concludes that CRT activity has been developing at a rapid rate characterised by significant product innovation, an increasing number of market participants, growth in overall transaction volumes, and perceived continued profit opportunities for financial intermediaries. The report further concludes that continued development of the CRT market offers potential benefits in the form of more liquid and efficient markets for the transfer of credit risk. The Joint Forum determined that the most important high-level issues associated with these developments relate to the need for market participants to continue improving risk management capabilities and for supervisors and regulators to continue improving their understanding of the associated issues. Accordingly, the report contains a series of recommendations for market participants and supervisors in the areas of risk management, disclosure, and supervisory approaches and an annex listing questions that supervisors of CRT market participants might consider as part of their supervisory activities.

The current work of the Joint Forum is focused in three workstreams. One of those involves identifying key differences in the regulatory approaches to similar risks across the banking, insurance, and securities sectors, particularly those that cannot be explained by intrinsic differences in the underlying business model and which might represent candidates for convergence in regulatory practices. Another, which is scheduled for completion in 2005, is a more narrowly focused cross-sectoral review of the practices for managing funding liquidity and the regulatory standards adopted by various jurisdictions in respect of this risk type. The latter stages of this work will focus on those aspects of industry and supervisory/regulatory practices of greatest interest in terms of their implications for the behaviour of the financial system generally and especially in times of stress. The third workstream aims to develop a set of high-level principles for business continuity for global application across financial sectors. The latter two initiatives will include appropriate liaison with other international groups interested in the areas, such as the CPSS, CGFS, and G10 Deputies.

## Financial Stability Institute

The mandate of the Financial Stability Institute (FSI) is to assist financial sector supervisors globally in implementing sound supervisory standards. The FSI strives to provide senior supervisors with a better understanding of supervisory techniques and an opportunity to learn about the latest supervisory developments. The FSI fulfils its mandate through a variety of means.

The FSI continues its programme of high-level meetings and seminars for banking and insurance sector supervisors around the world. These gatherings serve the important purpose of fostering cross-border supervisory contacts and cooperation. The FSI organises and delivers meetings and seminars on a wide range of topics of interest to senior supervisors. Such programmes allow supervisors from different countries to share experiences and exchange ideas for improved practices. Over the past several years, the FSI has had a particular focus on assisting supervisors in understanding the many components of the revised capital adequacy framework (Basel II) and analysing the options for implementation.

A major new initiative of the Institute is FSI Connect – an online information and learning resource that has been developed specifically to support financial sector supervisors. FSI

Connect was launched in mid-2004 and currently more than 85 central banks and supervisory authorities (representing more than 5,000 users) from approximately 74 jurisdictions have subscribed. FSI Connect offers courses on important topics, such as credit, market and operational risk, and capital adequacy (including Basel II). Tutorials on a full range of other banking and supervisory topics will be added continuously. FSI Connect is designed for supervisors at all levels of experience and expertise. FSI Connect is envisaged as a strong complement to the FSI's other activities and will enable the Institute to reach a wider audience of financial sector supervisors globally.

In early 2004, the FSI conducted a survey of around 120 countries to determine their current plans for the implementation of Basel II, as well as their needs for capacity building. This survey has provided guidance in developing a comprehensive plan for delivering future FSI support. The results of this survey are available on the BIS website under FSI occasional paper #4.

The FSI provides on an ongoing basis information to financial sector supervisors on supervisory developments and key issues affecting supervision. This is done primarily through its quarterly newsletter - *FSI World* - and the publication of occasional papers.

## V. Basel Committee publications

The Committee encourages the improvement of banking supervision techniques through public dissemination of its papers, primarily via its internet site (www.bis.org/bcbs). The main publications and working papers issued by the Committee since June 2004 are listed below:

- *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, June 2004
- *Implementation of Basel II: Practical Considerations*, July 2004
- *Principles for the Management and Supervision of Interest Rate Risk*, July 2004
- *Consolidated KYC Risk Management*, October 2004
- Working paper – *Studies on the Validation of Internal Rating Systems*, February 2005
- *Outsourcing in Financial Services* (Joint Forum), February 2005
- *Credit Risk Transfer* (Joint Forum), March 2005
- *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* – Consultative Paper (in association with IOSCO), April 2005
- *Compliance and the compliance function in banks*, April 2005