Basel Committee
on Banking Supervision

Report for the G7 Summit in Kananaskis

May 2002

BANK FOR INTERNATIONAL SETTLEMENTS

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Report for the G7 Summit

Executive Summary

Over the past year, the Basel Committee on Banking Supervision has continued its efforts to promote global financial stability through the refinement and development of guidance on key banking supervisory issues. The Committee has aggressively pursued the development of a new framework for assessing bank capital adequacy, which is its most prominent initiative. It has also taken up substantial work to combat the financing of terrorism and to strengthen prudential supervisory standards in major financial markets globally. In meeting these and other objectives, the Basel Committee has consulted extensively with other international bodies, including the Financial Action Task Force, the Financial Stability Forum, the International Accounting Standards Board, the International Monetary Fund, the World Bank Group, and the Offshore Group of Banking Supervisors.[1]

This report, prepared for the Group of Seven (G7) Finance Ministers and Central Bank Governors, discusses the Committee's progress over the past year.

- *The Committee has achieved notable progress in developing the new capital adequacy framework.* The Basel Committee's top priority over the past year has been to engage the industry in an active dialogue on its proposed new capital adequacy framework. To this end, the Committee issued for public discussion several working papers and has conducted quantitative impact studies to estimate the effect of its proposals on the level of capital that would be required of banks. The Committee expects to release the New Accord in final form by year-end 2003, and G10 member countries anticipate common implementation by year-end 2006.
- *The Committee has undertaken several projects to assist in combating the financing of terrorism.* For most immediate effect, the Committee has promoted the sharing across national boundaries of information about suspected terrorists. It has finalised its guidance on the conduct of customer due diligence by banks, which it views as a crucial step in combating terrorism, as well as in protecting the integrity of banking systems more generally. Going forward, the Committee will be reviewing present exchanges of information to determine whether additional guidance is needed.
- Working with representatives of non-G10 countries, the Committee has prepared practical guidance to assist banking supervisors in dealing with weak banks. This guidance comes in recognition that weak banks are a worldwide phenomenon.
- *The Committee has continued to provide guidance on the treatment of key banking risks.* Operational risk was singled out for attention over the past year. In addition, substantial work was accomplished on the supervisory issues arising from cross-border electronic banking activities.
- The Committee finalised a paper on the role of internal auditors in evaluating banks' internal controls and issued a separate paper on the relationship between external

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[1] The Committee also works closely with the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO) under the aegis of the Joint Forum and in other endeavours. The Joint Forum is submitting a separate report detailing its activities.

auditors and bank supervisors. Cooperation among the supervisor, the external auditor and the internal auditor would enhance the effectiveness of each of these parties. In addition, viewing transparency as an essential complement to prudential supervision, the Committee published its annual survey of banks' disclosure practices.

- The Committee continues to serve as a useful forum for bank supervisors from the major market economies to discuss and study other issues of concern. In addition to formal projects such as those mentioned above, the Basel Committee provided its members with many opportunities over the past year to discuss other emerging issues related to global banking and supervision. The collaborative orientation of the Committee, and its members' mutual commitment to its mission, has helped to forge strong working relationships and promote more effective coordination in response to immediate concerns.

The first section of this report discusses the Basel Committee's most current work to revise the 1988 Basel Capital Accord. The second section focuses on the Committee's efforts to date to assist in combating the financing of terrorism. The third section covers the Committee's other major initiatives over the past year, including providing guidance on issues related to financial stability, sound risk management, weak banking organisations, and accounting policy. An appendix lists the policy papers released by the Committee over the past year.

I. The New Basel Capital Accord

Since the release of the second consultative paper on the New Basel Accord in January 2001, the Basel Committee has made consultation with the industry a priority. The Committee reviewed all of the comments received on that paper and released, in response, working papers (outlined in the attached list of publications) for further discussion with the industry over the course of the year. Quantitative impact studies have played prominent roles in these discussions, which also include many informal meetings.

The consultations with the industry and the public have helped the Committee to enhance and strengthen its proposals. As indicated in its press release of December 2001, the Committee has set a high standard for the third and final consultative paper, which is expected to represent a fully specified proposal for the new capital adequacy framework. Accordingly, the Committee continues to solicit feedback from the industry in a variety of ways.

Undertaking independent empirical exercises remains an important part of this dialogue. The third and most comprehensive quantitative impact study is scheduled for autumn 2002. This exercise will be targeted to a wider set of banks worldwide than the previous studies. Approximately 165 banks will be asked to assess the impact of a fully specified proposal on their minimum regulatory capital levels. After evaluating the results, the Committee will release its proposal for a third and final round of formal consultation. The Committee expects to release the New Accord in final form by year-end 2003. Member countries of the Basel Committee are expected to implement the New Accord by year-end 2006.

Now that the work on the New Basel Accord is nearing completion, the Committee has begun to plan for its implementation. It has created the Accord Implementation Group (AIG) to help share information among Basel Committee members about bank and supervisory practices related to adoption of the new framework. Through this kind of contact, the AIG aims to promote greater convergence across jurisdictions in supervisors' approaches to implementation. To assist supervisors from other countries, the Committee intends to work with the Financial Stability Institute to facilitate the exchange of information among other supervisors as their banks adopt the new framework.

Details on specific areas of progress on each of the three pillars that comprise the New Accord – minimum capital, supervisory review and market discipline – follow below.

Pillar 1: Minimum Capital Requirements

Minimum capital requirements comprise the first pillar of the new capital framework. Comments received from the industry offered broad support for the Committee's objective of providing banks and their supervisors with a range of increasingly sophisticated options for the assessment of capital adequacy. The options for addressing credit risk, for example, range from the "standardised approach," which represents a relatively simple revision of the 1988 Basel Accord's risk-bucketing approach, to the "internal ratings-based approach," which incorporates for the first time a greater emphasis on banks' own assessments of credit risk.[2]

As explained in past reports to the G7 Finance Ministers and Central Bank Governors, the Committee believes that this framework provides banks with capital incentives to improve their risk management capabilities, which, in turn, should help to produce more sensitive capital requirements. At the same time, the Committee recognises that the regulatory capital regime must be both practical and clear. Consequently, in developing the key elements of the three-pillar framework, the Committee has sought the right balance between risk sensitivity and simplicity.

- *Creating incentives to make use of the more sophisticated, internal ratings-based approaches*

  With regard to the first pillar, a major priority for the Committee over the past year has been to calibrate the overall level of capital generated by the New Accord properly and effectively. The accurate calibration of the New Accord's "risk weights" (which determine how much capital is to be held against an exposure) is fundamental to the goal of creating a more risk-sensitive framework for regulatory capital. Responses from the industry on a quantitative impact study conducted earlier in 2001 suggested that some of the IRB risk weights in the January 2001 proposals were set so high that the Committee would not have created the incentives it intended to encourage banks to move to the more advanced approaches. In response, the Committee adjusted the risk weights of the IRB approach, and a subsequent quantitative impact study later in 2001 indicated that the proper incentives were better achieved.

- *Reducing the complexity of the New Accord*

  Over the past year, the Committee has responded to concerns raised by the industry about the complexity of the New Accord. The Committee has long acknowledged that the New Accord cannot address every risk to which a bank may

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2 The IRB approach places greater emphasis on banks' own estimates of key elements of credit risk, such as the probability of a borrower defaulting. To this end, the Committee has developed "foundation" and "advanced" IRB methodologies, under which banks that meet increasingly rigorous standards can rely on internal estimates of a greater number of risk components. The Committee's proposals for operational risk charges are also based on a range of options, which include the basic indicator, standardised, and advanced measurement approaches.

be exposed and that undue complexity may hinder the New Accord's implementation and effectiveness. The Committee has reached agreement on many ways to simplify the minimum capital requirements while still promoting their effectiveness.

- *The treatment of loans to small- and medium-sized enterprises*

  Respondents to the second consultative paper also raised concerns that the cost of borrowing would rise for small- and medium-sized enterprises (SMEs) under the New Accord. Recognising the vital importance that SME's play in promoting growth and innovation, and creating jobs in market economies, the Committee is determined to modify the New Accord to facilitate the availability of credit on reasonable terms to these enterprises. Over the past year, the Committee also refined some additional technical proposals concerning credit risk management. These include proposals related the recognition of credit risk mitigation techniques and the treatment of exposures arising from specialised lending programmes and the use of securitisation structures. Some of this work, and relevant consultation with the industry, remains ongoing.

Pillar 2: Supervisory Review Process

The second pillar provides guiding principles for the supervisory review of capital adequacy. Under the New Accord, banks are expected to assess their overall capital levels relative to their risks, and supervisors are expected to review those assessments and respond appropriately.

Currently, the Committee is considering how to revise the second pillar to incorporate, for example, banks' use of stress testing. Such tests can help banks to determine how much capital is necessary to protect them against adverse or uncertain economic conditions. Other refinements to the second pillar will include review of concentration risk and the treatment of residual risks that arise from the use of collateral, guarantees and credit derivatives.

Pillar 3: Market Discipline

Market discipline, the third pillar, is an important ally of prudential supervision and reinforces minimum capital standards and the supervisory review process, thereby further promoting safety and soundness in the banking system. In promoting greater transparency in public reporting, the Committee recognises the need for market participants to base their assessments of banks' risk exposures, management processes, and capital adequacy on timely information. However, it does not want to impose unusually burdensome disclosure requirements on banks. Accordingly, the Committee has taken note of the views of many respondents that the Pillar 3 proposals outlined in its second consultative package may have been too far-reaching.

Since then, the Committee, in a September 2001 working paper, scaled back the number of items proposed for disclosure to those believed essential to provide true insight into a bank's risk exposure and overall financial condition. The list of items required for disclosure may be further refined as the New Accord is finalised.

The Committee also maintains an ongoing dialogue with the accounting authorities, such as the IAS30 Advisory Group, to promote consistency between disclosure frameworks.

II. Combating the Financing of Terrorism

Following the horrendous events of 11 September, the G7 Finance Ministers and Central Bank Governors clearly expressed their commitment to combating terrorist financing. This objective is strongly endorsed by the Basel Committee. As one step in the effort, the Committee, working with the BIS, has acted as a clearing house for names of individuals and organisations suspected of being connected with terrorism by circulating lists of such names to banking supervisors on behalf of law enforcement authorities. The expectation is that the national authorities would request the banks in their countries to notify the appropriate authorities if they have accounts belonging to the named parties.

In December 2001, the Committee sponsored a meeting of supervisors and legal experts on the sharing of information about suspected terrorists between jurisdictions and published a summary of that meeting. Viewing terrorism as a threat to financial stability, the participants agreed that central banks and banking supervisors should lend their expertise and resources to treasuries, judicial authorities and law enforcement authorities, both within and across borders. The participants also concluded that it is important for each financial group to have an adequate means of group-wide, centralised risk management and that home country supervisors should be informed if any foreign branch or subsidiary is providing financial services to terrorists. Going forward, the Committee will be reviewing the experiences of bank supervisors and other official authorities in the exchange of information in order to determine whether further steps need to be taken to ensure that such exchanges are effective.

An important element in combating the illegal use of the banking system is the establishment of a highly effective customer due diligence programme. This would include thorough customer acceptance and identification practises, ongoing transaction monitoring and robust risk management. A 1999 survey found that know-your-customer practices varied significantly among countries, highlighting the need for a set of standards applicable to all banks in all countries. In January 2001 the Committee, working with representatives of the Offshore Group of Banking Supervisors, issued for comments a document providing guidance for banks in this area. After reviewing numerous written comments on this document, the Committee published a final version in October 2001.

Upholding due diligence is closely associated with the fight against money laundering. However, the Committee's paper takes a wider prudential perspective, that of protecting the integrity of banking systems. Nonetheless, the paper has been welcomed by the Financial Action Task Force (FATF) and is already serving as a reference in its review of its Forty Recommendations. The IMF and World Bank are also incorporating the Committee's customer due diligence standards in their methodology for assessing a country's efforts to combat money laundering and terrorist financing.

As was previously reported to the G7 Finance Ministers, the Committee has identified a number of jurisdictions deficient in their supervision of cross-border banking. The FATF had separately identified jurisdictions that did not appear to be cooperating effectively in fighting money laundering. The Committee is pleased to note that a number of these jurisdictions have agreed to increase their efforts in this area, particularly in the aftermath of 11 September.

In the future, supplementary guidance concerning issues that arise in relation to terrorist funding will be considered. Meanwhile, the Committee will continue its efforts to ensure that the standards contained in its paper *Customer due diligence for banks* are adopted around the world.

III. Other Efforts to Strengthen Bank Supervision

As indicated in earlier reports to the G7 Finance Ministers and Central Bank Governors, the Basel Committee strives to strengthen prudential supervisory standards in all major financial markets in both G10 and non-G10 countries. This objective is pursued in a variety of ways, including maintaining links with supervisors worldwide, publishing policy papers, and sponsoring and participating in conferences and training efforts. The Committee's work in developing prudential capital adequacy standards and due diligence principles was discussed above. This section highlights the Committee's efforts in developing guidance for dealing with weak banks, electronic banking, operational risk, transparency, the use of auditors, and cooperation among banking supervisors.

Supervisory Guidance on Dealing with Weak Banks

On several occasions in the past, the lack of contingency arrangements has resulted in delayed supervisory response to the problems of weak banks and, ultimately, in higher costs of resolution. Against this background and at the suggestion of the Financial Stability Forum (FSF), the Committee, in conjunction with representatives of non-G10 countries and several international bodies[3], prepared a "tool kit" for supervisors to assist them in dealing with weak banks.

Drawing on the experiences of many countries, this tool kit is intended to help both supervisors and the international financial institutions that advise supervisors understand the distinction between the symptoms and causes of bank problems. The Committee's report reviews a variety of bank problems, presents a range of possible responses and techniques, and outlines the advantages and disadvantages of each. The supervisory techniques include preventive measures, early identification, correction actions, and resolution or exit strategies.

The report recognises that a balance needs to be struck between rigid, prompt corrective actions and general, less binding frameworks. A balance also needs to be struck between informal methods of problem resolution and formal actions. Further, the paper addresses issues that could arise from a weak bank being part of a larger group or based in a foreign country.

The report is not intended to be prescriptive – rather it identifies examples of good practice that have been tested in other countries. Practical guidance is offered that can be adapted to the specific circumstances of each case.

Risk Management Principles for Electronic Banking

As requested by the G7 Finance Ministers at their Fukuoka meeting, the Basel Committee is continuing its efforts to establish principles and guidance for the supervision of electronic financial transactions. As one part of its response, the Committee is preparing a report on supervisory issues arising from cross-border electronic banking activities. These activities, while currently small, are expected to grow as banks expand their marketing strategies and customer acceptance increases.

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[3] The World Bank, the IMF, the European Commission, and the BIS Financial Stability Institute.

The forthcoming report is expected to serve two purposes. First, it will stress the responsibility of banks to conduct adequate due diligence, to have appropriate risk management systems in place, and to disclose their own identity to potential customers. In emphasising these sound management principles, the report supplements the Committee's May 2001 paper, *Risk Management Principles for Electronic Banking.* Second, the report will provide guidance for supervisors confronted with issues in cross-border e-banking. Such issues are likely to arise, for example, when a foreign bank or non-bank entity offers e-banking services in a country where it has no physical presence. Such situations were not contemplated when the present Basel Concordat was crafted.

The Committee has also pursued other ongoing initiatives in the electronic banking area by (i) promoting cooperative international efforts within the industry to identify electronic banking issues and sound practices to deal with them, (ii) facilitating the exchange of relevant training materials and guidance being developed in various countries, and (iii) chairing a working group of the FSF, IOSCO, IAIS, OECD and APEC[4] to explore electronic transaction issues that span the banking, securities and insurance sectors.

Management and Supervision of Operational Risk

One of the Committee's major activities is the provision of guidance to banks and supervisors on the treatment of key banking risks. Following earlier work on market, credit and liquidity risks, the Committee has conducted extensive studies of operational risk over the past year. Developing banking practices, including the increasing use of automation, very large-volume provision of services, greater use of outsourcing, and evolving risk mitigation techniques, involve substantial operational risk.

To further its dialogue with the industry, the Committee published in December 2001 a consultative paper on sound principles for the management of operational risk. The framework formed by these principles is based on methods for identifying, measuring, monitoring and controlling operational risk, as well as recognition of the important roles of supervision and market disclosure.

In order to create a more comprehensive and sensitive approach to addressing risks at individual institutions, the Basel Committee has proposed to include in the New Capital Accord an explicit capital charge for operational risk. In doing so, the Committee recognises that operational risk measurement is currently in a developmental stage. A working paper, released in September 2001, outlines the Committee's current thinking.

Given the rapid pace of evolution of approaches for the management of operational risk, the Committee believes that an active exchange of ideas between banking supervisors and the industry is crucial to further development of appropriate supervisory guidance in this area.

Transparency

As testified by the third pillar of the proposed New Basel Capital Accord, the Committee firmly believes that transparency in national and international banking systems is an essential complement to prudential supervision. Not only has the Committee produced papers on the best practices for disclosure, but also it conducts periodic surveys of banks' practices in this

[4] Asia-Pacific Economic Cooperation.

area. The results of its 2000 survey show that the most basic information related to banks' accounting policies, capital, credit risk, and market risk is well disclosed. Disclosure rates generally decrease as the sophistication, complexity, or degree of proprietary of the information increases. While there appears to be a modest overall increase in disclosures as compared to 1999, there is room for improvement in some of the areas identified for disclosure under the proposed Pillar 3.

The Committee has co-sponsored the Multidisciplinary Working Group on Enhanced Disclosure, which published a set of recommended disclosures in April 2001. Presently, the Committee is encouraging the Joint Forum in its review of the implementation of the Working Group's recommendations.

Accounting and Auditing

Accounting and auditing practices can have a significant impact on supervisors work to promote safe and sound banking. In August 2001 the Committee finalised a paper on the responsibilities of internal auditors to independently evaluate banks' internal control systems. While a bank's board of directors has the ultimate responsibility for ensuring that the bank has an effective system of internal controls, the internal audit function assists the management and the board in discharging this responsibility. Banking supervisors must be satisfied that effective policies and procedures are followed and that management takes appropriate corrective action in response to internal control weaknesses identified by auditors. Cooperation among the supervisor, the external auditor and the internal auditor would make the work of each of these parties more efficient and effective.

The Committee followed that paper with another that provides information on how the relationship between external bank auditors and supervisors can be improved to mutual advantage. This second paper was developed in association with the International Auditing and Assurance Standards Board (IAASB).[5]

The Committee remains involved in the development of international accounting and auditing standards relevant to banks. For example, the Committee is represented on the Standards Advisory Council of the International Accounting Standards Board and Consultative Advisory Group of the IAASB. It is an official observer of the International Forum on Accountancy Development and its steering committee. These positions assure the Committee opportunities to comment on drafts of relevant proposed accounting and auditing standards.

One of the topics the Committee has been following closely is a proposal to apply fair value accounting to virtually all financial instruments. This issue is of critical importance for banks because it would significantly affect they way they account for assets and liabilities not in the trading account. In September 2001, the Committee completed its analysis of the proposal, which served as the basis for a comprehensive comment letter.

Still another way in which the Basel Committee supports the use of international standards for accounting and auditing is its development, in collaboration with the Financial Stability Institute, of a programme to train banking supervisory staff in this area.

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[5] Formerly the International Auditing Practices Committee of the International Federation of Accountants.

Discussion, Information Sharing, and Coordination

The member agencies continue to view the Basel Committee as a valuable forum for sharing information on, and discussing, other emerging issues on global banking and supervision, including on topics for which no formal papers are prepared. Over the past year, for example, members of the Committee have made effective use of its meetings and working groups to discuss and study issues related to banks' exposures to troubled industries or regions. Topics have included the effects of corporate failures, such as Enron, on markets and on accounting policies, as well as the implications of the financial crisis in Argentina for banking and financial systems worldwide. The Committee's collaborative orientation has helped to forge strong working relationships among senior officials and staff from the member countries' bank supervisory agencies and central banks. The high level of cooperation and mutual commitment to the Basel Committee's mission has been particularly beneficial in coordinating effective responses to these and other emerging issues among its members, such as combating terrorist financing.

Cooperation among Banking Supervisors

A number of non-G10 countries have pointed out the desirability of having a reference document for establishing bilateral relationships between banking supervisory authorities in different countries and, where appropriate, between banking supervisors and other financial regulators. In response, the Basel Committee, in conjunction with the Offshore Group of Banking Supervisors, developed a framework for the essential elements of a statement of mutual cooperation between supervisors. This framework is applicable both in instances where a legal document is preferred by the parties involved and in instances where a simpler and more flexible understanding is established by an informal exchange of letters. In this connection, an important key to the success of any arrangement is that the supervisory authorities involved build a good working relationship with one another, with mutual trust and a willingness to share information when the circumstances justify it.

In September 2002, the 12th International Conference of Banking Supervisors will be held in Cape Town, South Africa. Delegates from more than 100 countries are expected to attend. This biennial event, jointly sponsored by the Basel Committee and the South African Reserve Bank, is designed to promote cooperation among national authorities in the supervision of international banking. The ICBS also enables senior representatives from supervisory authorities in a large number of countries to exchange views on issues of common concern. This year, the discussions will focus on recent developments concerning the New Basel Capital Accord and on how to foster a stable financial environment in emerging market countries.

IV. Basel Committee Publications

The Basel Committee is committed to encouraging the improvement of banking supervision techniques through public dissemination of its papers, primarily via its Internet site (www.bis.org/bcbs). In addition, it prepares and updates annually a *Compendium of Documents Produced by the Basel Committee on Banking Supervision*. This compendium represents a comprehensive set of statements concerning ongoing supervisory policy that the Committee has issued over the years.

While a large number of papers released by the Committee over the past twelve months related to the development of the New Basel Capital Accord, many deal with other topics of interest to the banking community and its supervisors. The main publications and working papers issued since May 2001 are listed below.

Publications

- *Public disclosures by banks: results of the 2000 disclosure survey,* May 2002
- *Sharing of financial records between jurisdictions in connection with the fight against terrorist financing*, April 2002
- *Supervisory Guidance on Dealing with Weak Banks*, March 2002
- *The relationship between banking supervisors and banks' external auditors*, January 2002
- *Sound Practices for the Management and Supervision of Operational Risk*, December 2001
- *Customer due diligence for banks,* October 2001
- *Internal audit in banks and the supervisor's relationship with auditors*, August 2001
- *Essential elements of a statement of cooperation between banking supervisors*, May 2001
- *Risk Management Principles for Electronic Banking,* May 2001

Working Papers for the New Basel Capital Accord

- *Treatment of Asset Securitisations,* October 2001
- *Internal Ratings-Based Approach to Specialised Lending Exposures,* October 2001
- *Regulatory Treatment of Operational Risk*, September 2001
- *Pillar 3 – Market Discipline,* September 2001
- *Risk Sensitive Approaches for Equity Exposures in the Banking Book for IRB Banks*, August 2001
- *IRB Treatment of Expected Losses and Future Margin Income,* July 2001

Quantitative Impact Studies

- *The Quantitative Impact Study for Operational Risk: Overview of Individual Loss Data and Lessons Learned,* January 2002
- *QIS 2.5 Exercise and Instructions,* November 2001
- *Potential Modifications to the Committee's Proposals*, November 2001
- *Results of the Second Quantitative Impact Study*, November 2001
- *QIS 2: Operational Risk Data*, May 2001
- QIS Frequently Asked Questions, May 2001