Serge Jeanneau

+41 61 280 8416
serge.jeanneau@bis.org

Recent initiatives by Basel-based committees and the Financial Stability Forum

Basel Committee on Banking Supervision (BCBS)

In January, the BCBS issued an updated and expanded version of its paper *The relationship between banking supervisors and banks' external auditors*, jointly developed with the International Auditing Practices Committee (IAPC) of the International Federation of Accountants.[1]

The BCBS and IAPC look at the relationship between bank auditors and supervisors ...

The purpose of the paper is to provide information and guidance on how the relationship between bank auditors and supervisors can be strengthened to their mutual advantage, taking into account the Basel Committee's *Core Principles for Effective Banking Supervision*. Specifically, the paper describes the primary responsibilities of the board of directors and management, examines the essential features of the role of external auditors and supervisors, reviews the relationship between external auditors and bank supervisors, and describes additional ways in which auditors can contribute to the supervisory process.

... with a view to fostering coordination between the two groups

The BCBS and the IAPC share the view that a greater understanding among banking supervisors and external auditors of their respective tasks and responsibilities and, where appropriate, more communication between them will improve the effectiveness of bank audits and supervision, to the benefit of the public at large. Both committees recognise that, because the nature of the relationship between auditors and bank supervisors varies significantly from country to country, the guidance may not be applicable in its entirety to all countries. Nonetheless, it will provide a useful clarification of the respective roles of the two professions in the many countries where significant working relationships exist or where the relationship is currently under study.

Also in January, the BCBS made public a paper providing an overview of the individual loss event data collected as part of the second data collection exercise conducted under the Quantitative Impact Study (QIS) on operational

1 The IAPC is issuing the paper as an International Auditing Practice Statement. Such statements are issued by the IAPC to provide practical assistance to auditors in implementing the International Standards on Auditing or to promote good practice.

The BCBS describes the data collected under its QIS ...

risk (QIS2-Tranche 2).[2,3] The goal of this overview is to illustrate the nature of the data collected, to provide some insight into the types of issues that can (and cannot) be addressed with the data, and to suggest some areas of further refinement for any future QIS data collection exercises. To that end, the final section of the paper reports on some "lessons learned" through the QIS exercises. The purpose of this section is to stimulate discussion with the banking industry and other interested parties that could help identify possible improvements.

... and releases a report on the supervisory guidance of weak banks

In March, the BCBS published a report providing supervisory guidance on dealing with weak banks.[4] The report offers practical help in the areas of problem identification, corrective action, resolution techniques and exit strategies. It notes that supervisors should be sufficiently prepared to deal with a range of contingencies. In a crisis, time is short and problems need to be dealt with as quickly as possible. Delays can aggravate the situation and make solutions more costly. Supervisors should understand the issues and the options for handling weak banks. They should also know with whom to communicate in other organisations and countries when the need arises.

Supervisors need to be discriminating. They have to distinguish between the symptoms and the underlying causes of bank weakness, which will influence their choice of corrective action. While supervisors have to allow for special factors at state banks and international conglomerates, this does not imply forbearance or leniency. They also have to be proportionate and flexible in their use of available tools, judging when a remedial programme is more appropriate than penalties and when (and when not) to publicise restrictions.

The report makes clear that banks can and do fail and that the public should be aware of this. Liquidation is often the right solution but before such a measure is taken there are a number of proven resolution and exit techniques which can minimise disruptions to the financial system. Public bailouts are a last resort.

Committee on the Global Financial System (CGFS)

The CGFS publishes a paper on the implications of innovation in IT

In February, the CGFS published a paper discussing the implications for the financial system of innovations in information technology (IT).[5] It notes that IT has fundamentally changed the way economic activity is carried out and organised. The eventual macroeconomic outcome of these changes and the

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2 See *The quantitative impact study for operational risk: overview of individual loss data and lessons learned*, BCBS, Basel, January 2002. Available at www.bis.org.

3 The paper focuses on describing the range of individual loss data submitted by the banks participating in the survey, understanding the range of individual gross loss amounts contained in the data sample and examining information provided on insurance and other recoveries associated with loss events.

4 See *Supervisory guidance on dealing with weak banks*, BCBS, Basel, March 2002. Available at www.bis.org.

5 See *IT innovations and financing patterns: implications for the financial system*, CGFS, Basel, February 2002. Available at www.bis.org.

profile of an IT-based economy are still uncertain. Nevertheless, evidence of structural changes in different countries is abundantly available at the microeconomic level, with implications for firms' financial structure and the character of financial intermediation.

The report emphasises that IT-related changes in business models and in the competitive environment may alter the risk-return profile of firms quickly and in an unpredictable way. Such an outcome increases the need for capital that bears business risk, namely equity and financial contracts that incorporate equity characteristics.

The risks lie in the failure of large projects

The main risks involved in the financing of new technologies are large-scale failures of investment projects that may damage the financial institutions providing funding, and excessive price movements in financial markets resulting from unrealistic expectations. Against this background, the report reaffirms that the task of financial policy is to set a framework of standards and guidelines that allows for market-driven adjustment of financing mechanisms and encourages ongoing improvement in risk management techniques.

The report also notes that central banks can play an active role in this process. One aspect of this role is employing the research capabilities and knowledge of the financial system found in central banks to improve understanding of the financial impact of technological change. The other aspect is active monitoring of the financial system. Changing linkages between the real and the financial sphere and across the different segments of the financial system, and, in particular, the reallocation of risks across the financial system underline the need for systemic monitoring.

Financial Stability Forum (FSF)

The FSF calls for vigilance over financial imbalances

The FSF met on 25–26 March in Hong Kong SAR.[6] Participants at the meeting noted that core financial systems had been seriously put to the test but that they had displayed considerable resilience. However, members agreed that the possible interaction of only a mild recovery in global activity with continued financial imbalances called for ongoing vigilance and supervisory cooperation.

The FSF discussed possible financial stability issues arising from recent large corporate failures, noting the widespread relevance of these issues to many countries and the potential repercussions for market integrity. At the suggestion of its G7 members, the FSF Chairman submitted a report on the work taken forward to G7 Ministers and Governors, and the FSF itself will discuss the matter further in Toronto in September 2002.

The FSF also discussed progress in efforts to combat the financing of terrorism. Members took note of the important work currently being carried out by national authorities, the Financial Action Task Force (FATF), the IMF and World Bank and standard-setting bodies, which should strengthen the fight against terrorism financing. The FSF will provide a report to the G7 and G20 on these efforts. FSF members urged all non-FATF members that have not

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6 For information on the FSF, its membership and its activities, readers are invited to visit the FSF website at www.fsforum.org

already done so to conduct a self-assessment of their compliance with the FATF's Special Recommendations on Terrorism Financing by 1 May 2002.

In reviewing progress by offshore financial centres (OFCs) in strengthening their supervisory, regulatory, information sharing and cooperation practices, FSF members underscored the heightened importance for all jurisdictions, including OFCs, of enhancing their implementation of international standards to strengthen the international financial system. FSF members recalled that the FSF classification of OFCs issued in May 2000 aimed at encouraging OFCs to implement international standards and helping the IMF in setting priorities for assessments. Such assessments have been completed in a number of OFCs and are under way in many others. Good progress by some OFCs in improving their implementation of international standards was generally seen by FSF members on many fronts. Others, however, were lagging behind. The FSF will regularly consider progress by OFCs, drawing on supervisory experience gathered through contact meetings and periodic updates by the IMF. On the basis of these considerations, the FSF will draw public attention to those OFCs that give cause for serious concern, while it may also point out positive developments by OFCs as a model for others.

FSF sees progress by some OFCs

The FSF also discussed how far previous concerns relating to highly leveraged institutions (HLIs) had been allayed by the implementation of its March 2000 recommendations, taking account of changes within the industry and market environment. It was noted that improved counterparty risk management, strengthened regulatory oversight of hedge fund counterparties and gains in information flows had contributed to reducing leverage. These developments had lessened the risks that hedge funds could pose for the international financial system. However, the FSF warned against complacency and urged continued improvements in public disclosures by hedge funds to strengthen market discipline and reduce systemic risk.

Crisis Management Contact List drawn up

Moreover, the FSF reviewed operational issues arising in financial markets in the context of 11 September 2001 and lessons being drawn with regard to contingency arrangements. The FSF will consider these issues in more depth at its next meeting. It also welcomed the development of a Crisis Management Contact List to facilitate crisis management. The list covers central banks, supervisory/regulatory agencies, finance or treasury departments and key international financial institutions as well as global service providers in some 30 countries. Lastly, it agreed that the Recommendations for securities settlement systems, prepared by the CPSS and IOSCO, and the FATF's Special Recommendations on Terrorism Financing, would be included in the key standards highlighted by the FSF for sound financial systems.