

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

The various Basel-based committees and the Financial Stability Forum (FSF) took a number of initiatives during the fourth quarter of 2005. The FSF held its fourth Latin American meeting, as well as a meeting with representatives of the hedge fund community and their counterparties. At the FSF's request, the Joint Forum published a consultative paper on high-level principles for business continuity. The Basel Committee on Banking Supervision (BCBS) released two consultative papers, the Committee on the Global Financial System (CGFS) published a report on housing finance and the Committee on Payment and Settlement Systems (CPSS) issued three new publications. Table 1 provides a selective overview of these and other recent initiatives.

Financial Stability Forum

The Financial Stability Forum held its fourth Latin American regional meeting in Mexico City in November 2005. It also met with representatives of the hedge fund industry and their counterparties in London and New York.

At the *fourth Latin American regional meeting*, participants exchanged views on strengths and vulnerabilities in the international and regional financial systems and on recent progress in developing domestic securities markets. They also shared experiences on strengthening financial systems and reviewed the state of the banking sector.

At the meeting, it was noted that global and regional economic growth had been resilient in recent years and that continued expansion was expected. The region had benefited from improvements in the terms of trade, as well as lower funding costs and strong capital inflows supported by highly accommodative global financial conditions. Policymakers had generally succeeded in taming the high inflation rates experienced in the past, while flexible exchange rates had helped reduce vulnerabilities. Participants noted that it was important for regional economies to manage the consequences of these currently benign conditions, by using the opportunity to strengthen their economies and financial systems to deal with potentially more difficult times ahead. In this context, participants stressed the need for continuing structural reforms and fiscal discipline, as well as further consolidation of debt and improvements in debt management practices. They agreed on the importance of clear communication

At its fourth Latin American regional meeting ...

... the FSF notes the need for continuing structural reforms and fiscal discipline

of policy priorities, including the commitment to price stability as the overriding objective of monetary policy.

Progress in promoting the growth of Latin American domestic securities markets was evaluated. Recent developments were seen as having brought benefits to both public and private issuers, including lower exposure to foreign exchange risk and a more diversified investor base. Demand for domestic securities has been growing rapidly, both from the increasingly important domestic institutional investor sector, in particular pension funds, and from foreign investors. Views were exchanged on the appropriate sequencing of policies in this area, including the development of market infrastructure, the fostering of a diverse set of domestic investors with adequate risk management skills, and the development of derivatives markets. A remaining challenge was to encourage greater private sector issuance, including measures to reduce the crowding-out of such issuance by government debt.

Development of domestic securities markets and policy implications

Participants shared experiences with regard to the strengthening of financial systems, with particular focus on the prioritisation of reforms (a process seen as especially challenging given countries' multiple reform goals and limited resources), on assessments against international standards and on the need for enhanced prioritisation by the setters and assessors of standards.

Need for prioritisation of reforms

In a context of stabilising economies and strengthened supervisory frameworks, it was noted that banking sector profitability and capitalisation had improved across the region. Foreign-owned institutions were playing an important role, providing capital and expertise, including in risk management. However, they were also posing challenges for policymakers and supervisors, especially as regards coordinating home and host supervision.

Stocktaking on state of banking sectors

The FSF held two *informal workshops with members of the hedge fund community and their counterparties* in London and New York. Current developments in the hedge fund sector were discussed, together with risks in the present market environment, risk management challenges for hedge funds and their counterparties, and a range of operational issues. Participants noted growing institutional investor interest in the sector. This has brought increased investor scrutiny to the industry, with expectations of greater professionalism and more disciplined management practices. Recognising that the current accommodative market environment (including favourable credit conditions and ample financial market liquidity) may not endure, participants agreed on the critical importance of adequate counterparty risk management practices, including appropriate haircuts and other collateral management techniques. Participants also discussed operational issues in the market for credit derivatives. While they noted the progress recently made by the industry to reduce documentation backlogs, improve assignment procedures and facilitate settlement, further progress was deemed necessary to enhance market stability.

Informal workshops with hedge funds and their counterparties

Joint Forum

At the request of the FSF, in December the Joint Forum released a consultative paper on *high-level principles for business continuity*, to help authorities

Joint Forum sets out high-level principles for business continuity

develop business continuity arrangements which are tailored to their own sectoral and local circumstances. The paper, open for comments until 10 March 2006, sets out seven principles:

- (i) the definition of responsibilities;
- (ii) the importance of performing active business continuity planning;
- (iii) the need to tailor recovery operations to the risks posed to the financial system;
- (iv) the importance of internal and external communication;
- (v) specific provisions for cross-border communication;
- (vi) periodic testing;
- (vii) implementation and review.

Basel Committee on Banking Supervision

In November 2005, the Basel Committee on Banking Supervision issued two consultative documents. One paper related to sound credit risk assessment and valuation for loans, and a second to home-host information sharing for the effective implementation of Basel II. The two papers were open for comment until 28 February. In addition, the Committee also provided clarification regarding the treatment of expected operational risk losses when using advanced measurement approaches.

BCBS releases consultative papers on sound credit risk assessment and valuation for loans ...

Inadequate credit risk assessment policies and procedures, which may lead to untimely recognition and mismeasurement of loan losses, undermine the usefulness of capital requirements and hamper proper assessment and control of a bank's credit risk exposure. Given the importance of this topic, the BCBS issued a consultative paper on *sound credit risk assessment and valuation for loans*, which provides banks and supervisors with guidance in this area, regardless of the accounting framework applied. The document discusses the use of common data and processes for credit risk assessment, accounting and capital adequacy, and highlights provisioning concepts that are consistent with both the prudential and accounting frameworks. It also focuses on policies and practices believed to promote sound credit risk assessment and controls, including the responsibilities of the board of directors and senior management for maintaining aggregate provisions for loan losses.¹

The paper also presents general guidelines on how supervisors should evaluate the effectiveness of a bank's credit risk policies.

... and on home-host information sharing for effective Basel II implementation

Also in November, the Basel Committee released, in association with the Core Principles Liaison Group, a consultative paper on *home-host information sharing for effective Basel II implementation*. The paper elaborates on some of the high-level principles for cross-border implementation of the new framework, specifically by laying out general principles to guide the information sharing

¹ Most of the guidance relates to the advanced internal ratings-based approach under Basel II, although some of it is applicable to all banks irrespective of the approach they are using. The paper focuses on loans carried at amortised cost, but some parts of it are believed to be relevant for addressing credit risk assessment and valuation issues pertaining to assets other than loans carried at amortised cost and other credit exposures.

Main initiatives by Basel-based committees and other bodies			
Press releases and publications over the period under review			
Body	Initiative	Thematic focus	Release date
FSF	<i>FSF meets with the hedge fund community and its counterparties</i>	<ul style="list-style-type: none"> Trends in the hedge fund sector, risks in the present market environment, risk-management challenges for hedge funds and their counterparties, operational issues. 	Nov 2005
	<i>Fourth Latin American Meeting</i>	<ul style="list-style-type: none"> Strengths and vulnerabilities in the international and regional financial systems and their consequences for emerging markets, sustainability of public debt. Recent policies to develop domestic securities markets, national experiences with strengthening financial systems. 	
Joint Forum	<i>Consultation paper on high-level principles for business continuity</i>	<ul style="list-style-type: none"> Establishes consistent context for the development of business continuity arrangements, aimed at financial industry participants and financial authorities globally. Provides a broad framework. 	Dec 2005
BCBS	<i>Consultative paper on sound credit risk assessment and valuation for loans</i>	<ul style="list-style-type: none"> Policies and practices to promote sound credit risk assessment, valuation and control processes, and to clarify the responsibilities of the board of directors and senior management. Assessment guidelines for supervisors. 	Nov 2005
	<i>Consultative paper on home-host information sharing for effective Basel II implementation</i>	<ul style="list-style-type: none"> General principles to guide the sharing of information between home and host country supervisors in the implementation of the Basel II capital framework. 	
	<i>Newsletter on the treatment of expected losses by banks using the advanced measurement approaches under Basel II</i>	<ul style="list-style-type: none"> Clarification of the appropriate treatment of expected operational losses in calculating regulatory capital charges for operational risk. 	
CGFS	<i>Housing finance in the global financial market</i>	<ul style="list-style-type: none"> Analyses the significance of developments affecting the supply of, and demand for, housing finance. Compares national housing finance systems. 	Jan 2006
CPSS	<i>Cross-border collateral arrangements</i>	<ul style="list-style-type: none"> Describes existing institutional arrangements, discusses alternative models for the acceptance of foreign collateral and identifies potential implications for financial stability, competition and the safety and efficiency of payment systems. 	Jan 2006
	<i>General guidance for payment system development</i>	<ul style="list-style-type: none"> Sets out 14 guidelines, based on consultation version of May 2005. 	
	<i>Statistics on payment and settlement systems in selected countries</i>	<ul style="list-style-type: none"> Preliminary statistics for 2004 	
Source: Relevant bodies' websites (www.bis.org and www.fsforum.org).			Table 1

process. These include the clear communication of home and host supervisory responsibilities to banking groups with significant cross-border operations, and timely communication of information between home and host country

supervisors – recognising that different information sets are relevant for these two parties. The paper also addresses the format, frequency and confidentiality of information sharing. The general principles are supplemented by practical examples of the information that host supervisors might need for effective Basel II implementation and supervision.

Four guiding principles to coordinate implementation of AMA across countries

Finally, in a newsletter prepared in response to queries from the industry, the BCBS provided clarification on the issue of the *treatment of expected operational risk losses in advanced measurement approaches (AMA) under the Basel II framework*. The newsletter offers four guiding principles to promote consistent implementation of AMA, while still leaving sufficient room for appropriate discretion by national supervisors.

Committee on the Global Financial System

CGFS report on housing finance identifies supply and demand factors ...

The CGFS set up a working group in November 2004 to study recent changes in housing finance systems as part of the Committee's ongoing work to guard against risks to financial stability. The report prepared by the working group, entitled *Housing finance in the global financial market* and published in January 2006, aims to analyse the significance of developments that are common across countries and affect the supply of, and demand for, housing finance. These include higher loan-to-value ratios, an increase in the range and complexity of mortgage products, the growing importance of capital markets in the funding of mortgages, and a greater willingness of households to take on interest rate and other risks. The report lists as important implications the possibility of overstretched household balance sheets, the greater reliance by financial institutions on capital market funding for housing finance, their resulting exposure to financial market volatility, and the need for careful management of credit, operational and reputational risks. For investors, mortgage-backed financial products offer diversification opportunities but also introduce a new source of market volatility. Policymakers need to ensure that they have access to a broad array of high-quality data to monitor possible vulnerabilities, and should foster stress testing and information exchange at an international level. At the same time they must remain mindful of how changes in the different national regulatory and other environments could impact on national housing finance systems and economies, as well as global financial markets.

... and highlights relevant policy issues

Committee on Payment and Settlement Systems

In January 2006, the CPSS released three publications: a report on cross-border collateral arrangements, general guidance for national payment system development, and a set of statistics on payment and settlement systems in selected countries.

In the area of cross-border collateral arrangements ...

The report on *cross-border collateral arrangements* describes existing institutional arrangements through which central banks accept collateral denominated in a foreign currency or located in a foreign jurisdiction to support intraday or overnight credit, either routinely or in an emergency. It also

discusses alternative models for the acceptance of foreign collateral. In addition, the report identifies the potential implications of a central bank's collateral policy for financial stability, competition and the safety and efficiency of payment systems. The variety of collateral policies and practices among central banks, participants' differing needs, procedures and varying national legal frameworks suggest a wide range of approaches regarding the acceptance of foreign collateral. Thus, the G10 central banks agreed on adopting an "à la carte" approach, under which each central bank decides independently whether and, if so, under what circumstances, to accept cross-border collateral. That said, further cooperation and coordination among central banks might be desirable if this increases the effectiveness of an individual central bank's policies and actions, or serves to help the private sector in developing more advanced tools for managing collateral and liquidity.

... G10 central banks agree on an "à la carte" approach

The *general guidance for payment system development* is based on a consultative paper released in May 2005.² It draws on the contribution of a working group composed of a broad range of central bank experts from developed and developing countries around the world. The report includes 14 guidelines and accompanying explanatory text on payment system development. In addition, there are implementation sections which illustrate the guidelines with practical examples, issues and possible approaches to implementation.

Publication of general guidance for payment system development

The *statistics on payment and settlement systems* are part of an annual publication that provides data on payments and payment systems in the CPSS countries. This most recent statistical update contains individual country data and cross-country comparisons for 2004 and earlier years.³

² See *BIS Quarterly Review*, September 2005.

³ Some data for 2004 are preliminary or missing; the CPSS intends to publish an updated version in March 2006.