

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

During the period under review, the Basel Committee on Banking Supervision (BCBS) organised the 14th International Conference of Banking Supervisors in association with the Mexican Banking and Securities Commission. One important outcome of that meeting was the endorsement of a revised version of the Core Principles for Effective Banking Supervision and the associated Methodology. The Joint Forum published a paper on High-level Principles for Business Continuity, and the Financial Stability Forum (FSF) held its 16<sup>th</sup> meeting in Paris. Table 1 provides a summary of these and other initiatives.

### Basel Committee on Banking Supervision

In September 2006, the BCBS provided clarification on the IRB use test. In October 2006, it acted as co-sponsor of the International Conference of Banking Supervisors in Mérida, Mexico, and released a paper on the observed range of practice in key elements of Advanced Measurement Approaches (AMA).

BCBS provides clarification on the IRB use test ...

In a newsletter published in September 2006, the Committee provided background on the evolution of its thinking on the *IRB use test*<sup>1</sup> and clarified expectations for the use of IRB components and risk estimates for internal purposes. It presented a number of principles intended to support banks and supervisors in interpreting the key use test provisions of the Basel II framework. The principles state that banks are responsible for demonstrating their compliance with the use test, and highlight the role of the material use of IRB components as a catalyst for quality control. They discuss consistency and differences between IRB components and internal measures and recommend that banks follow a holistic approach when assessing the overall compliance of their institution with the use test requirements.

At the International Conference of Banking Supervisors (ICBS) held in Mérida, Mexico, on 4–5 October 2006, bank supervisors from central banks and supervisory agencies in 120 countries endorsed the updated version of the

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<sup>1</sup> The IRB use test is a concept intended to test whether banks' IRB components (PD, EAD and LGD, which the Basel II framework requires banks to use for the calculation of regulatory capital) "play an essential role" in how banks measure and manage risk in their businesses.

Main initiatives by Basel-based committees and other bodies			
Press releases and publications over the period under review			
Body	Initiative	Thematic focus	Release date
BCBS	<i>The IRB use test: background and implementation</i>	<ul style="list-style-type: none"> <li>Background on the evolution of the Basel Committee's thinking on the use test for IRB; expectations for the use of IRB components and risk estimates for internal purposes</li> </ul>	September 2006
	International Conference of Banking Supervisors	<ul style="list-style-type: none"> <li><i>Core Principles for Effective Banking Supervision</i></li> <li><i>Core Principles Methodology</i></li> <li>Presence of international banks in domestic markets and the implementation of Basel II</li> </ul>	October 2006
	<i>Observed range of practice in key elements of Advanced Measurement Approaches (AMA)</i>	<ul style="list-style-type: none"> <li>Cross section of practices observed by supervisors in relation to some of the key challenges in the operational risk-related work of banks targeting the AMA</li> <li>Particular focus on internal governance, data and modelling</li> </ul>	
Joint Forum	<i>High-level principles for business continuity</i>	<ul style="list-style-type: none"> <li>Final version of consultation document issued in December 2005</li> </ul>	August 2006
FSF	<i>Sixteenth FSF meeting in Paris</i>	<ul style="list-style-type: none"> <li>Global risks and vulnerabilities</li> <li>Mitigation of risk in financial systems</li> <li>Enhancing the effectiveness of regulation and standard-setting</li> <li>Follow-up of ongoing concerns: avian flu pandemic and business continuity, offshore financial centres, and international accounting and auditing issues</li> </ul>	September 2006
	<i>Establishment of the International Forum of Independent Audit Regulators</i>		
Source: Relevant bodies' websites (www.bis.org).			Table 1

*Core Principles for Effective Banking Supervision* and of the associated *Core Principles Methodology*. They declared their continued support for the implementation of international minimum standards for bank supervision in all countries. Both documents had been issued for public comment in April 2006.<sup>2</sup>

The revision of the *Core Principles*, originally published by the Committee in September 1997, was a response to changes which have occurred in banking regulation and to the experience gained by individual countries with implementing the Principles. Furthermore, new regulatory issues, insights and gaps have become apparent, often resulting in new Committee publications. The Principles fall into seven broad categories: objectives, independence,

... and updates  
Core Principles for  
Effective Banking  
Supervision

<sup>2</sup> See "Recent initiatives by Basel-based committees and the Financial Stability Forum", *BIS Quarterly Review*, June 2006.

powers, transparency and cooperation (principle 1); licensing and structure (principles 2 to 5); prudential regulation and requirements (principles 6 to 18); methods of ongoing banking supervision (principles 19 to 21); accounting and disclosure (principle 22); corrective and remedial powers of supervisors (principle 23); and consolidated and cross-border banking supervision (principles 24 and 25). The revisions pay particular attention to sound risk management and corporate governance practices and cover common aspects across different risk types. The criteria for assessing interest rate, liquidity and operational risks have been enhanced; those dealing with the fight against money laundering and terrorist financing as well as fraud prevention have also been strengthened. In addition, cross-border and cross-sectoral trends and developments are reflected more comprehensively, as is the need for closer cooperation and information exchange between supervisors of different sectors and countries. The review also stresses the importance of the independence, accountability and transparency of bank supervisory authorities.

Participants at the ICBS also discussed issues arising from the growing presence of international banks in domestic markets. This second theme included, but was not limited to, issues arising from the implementation of the Basel II capital framework.

Release of paper on  
observed range of  
practice in key  
elements of AMA

On 13 October 2006, the BCBS released a paper entitled *Observed range of practice in key elements of Advanced Measurement Approaches (AMA)*. Despite the flexibility provided to banks in the development of an AMA, in recognition of the evolutionary nature of operational risk management, prudential supervisors have an interest in identifying and encouraging bank operational risk practices that are consistent with safety and soundness and level playing field objectives. Furthermore, the industry has, at various times, encouraged the Accord Implementation Group (AIG) and its subgroups to establish and maintain high standards for what constitutes acceptable practice and to publish "sound practice" papers to communicate those standards and promote consistency across jurisdictions. Against this background, the paper describes a cross section of the practices supervisors have observed in banks attempting to deal with operational risk issues under the AMA. It was prepared by the Operational Risk Subgroup (AIGOR) of the AIG.

No judgment is intended or implied regarding the acceptability of any of the practices reflected in this paper. For example, the fact that a particular practice is discussed should not be interpreted as an endorsement of that practice by the AIGOR or any of its members. Nor should the absence of a particular practice be interpreted to imply that it is, or is not, considered acceptable by supervisors. The principal purpose of the paper is to catalogue the key issues and corresponding practices observed among AMA banks operating in AIGOR member countries. As such, the paper provides the international community of bank supervisors with a means of framing the discussion of acceptable practice in both the management and the measurement of operational risk and monitoring the evolution of industry practice and supervisors' reactions. It is also expected to be a valuable resource for both banks and national supervisors to use in their respective implementation processes.

## Joint Forum

On 29 August, the Joint Forum published a paper entitled *High-level principles for business continuity*. A consultative draft of the paper had been issued for comment in December 2005.<sup>3</sup> The document promotes a common base level internationally for the resilience of financial systems to major operational disruptions. It provides authorities with a broad framework for developing business continuity arrangements that are more closely tailored to their unique sectoral and local circumstances. The principles outlined in the paper apply to both financial industry participants and financial authorities and are applicable across the banking, securities and insurance sectors.

Joint Forum publishes paper on high-level principles for business continuity ...

The paper sets out seven principles for business continuity covering the following specific areas: board and senior management responsibilities; incorporating the risk of major operational disruptions into business continuity plans; recovery objectives; communications; the special case of cross-border communications; testing; and business continuity management reviews by financial authorities.

... setting out seven principles ...

In response to the comments received on the consultative draft, a number of changes were incorporated in the final paper. In particular, the definition of a “major operational disruption” was expanded beyond events causing widespread damage to the physical infrastructure to include other risks such as pandemics and technology viruses. The dependence of financial authorities and financial industry participants on third parties for important aspects of their business continuity was also acknowledged, along with the corresponding implications for an organisation’s communication procedures. It was also recognised that employees’ availability might be reduced if their families were directly affected by the same event. The involvement of business line management in establishing recovery objectives was noted and expectations for the recovery objectives of critical market participants were clarified. Finally, the paper now notes that it could be beneficial to designate a “coordinator” to facilitate communication among relevant financial authorities during a major operational disruption affecting a group where the oversight responsibilities for the group are shared.

... and taking account of comments received

## Financial Stability Forum

In September 2006, the Financial Stability Forum held its 16th meeting. Representatives of the FSF also attended a roundtable in Paris where the International Forum of Independent Audit Regulators was inaugurated.

At the *16th FSF meeting* on 6 September in Paris, FSF members discussed risks and vulnerabilities in the international financial system and reviewed ongoing work to strengthen financial system stability and resilience. Particular attention was paid to firms’ risk management practices, to improvements in the infrastructure for over-the-counter (OTC) derivatives, and

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<sup>3</sup> See “Recent initiatives by Basel-based committees and the Financial Stability Forum”, *BIS Quarterly Review*, March 2006.

to enhancing the effectiveness of regulation and standard-setting. The Forum also discussed other ongoing concerns such as business continuity, offshore financial centres (OFCs), and international accounting and auditing issues.

Favourable economic outlook noted at 16th FSF meeting, despite some concerns

The FSF noted that the economic outlook remained broadly supportive of financial stability, given financial firms' strong balance sheets and their ability to adjust to the ongoing removal of accommodation in monetary policy in many countries and to shifts in the balance of demand among the major economies. However, members pointed to several areas of concern. These included whether households in some countries had the capacity to manage rising debt levels, the rapid pace of leveraged buyouts and debt-financed acquisitions, the growing complexity of financial instruments, and persistent global current account imbalances. Financial market participants need to take account in their risk analysis and pricing of the full implications of a possible reversal of the current benign conditions, including more volatile and less liquid markets.

The FSF encouraged financial firms to further strengthen their risk management practices. The need to run stress test scenarios involving low-probability, high-impact events or in which several vulnerabilities crystallise in combination was seen as particularly important.

Progress on credit derivatives settlement, but scope for further improvements in this area ...

Members also reviewed issues concerning the infrastructure for OTC derivatives, as well as the growing role of hedge funds and implications for counterparty risk management. They welcomed progress by financial firms in improving the trading and settlement infrastructure for credit derivatives, particularly in reducing backlogs of outstanding confirmations, and in further strengthening counterparty risk management relating to complex products. The recent good cooperation between the private and public sectors in addressing these problems provides a model for future work in other areas. Nevertheless, there is need for further progress in improving the infrastructure of these rapidly growing market segments, particularly in such areas as the automation of trade processing and settlement. More generally, members stressed the importance of developing reliable valuation practices for illiquid products. Concerning hedge funds, the Forum stressed the importance of financial firms maintaining appropriate margining practices and guarding against any weakening of credit standards in prime brokerage and other counterparty relationships. Hedge funds themselves should make further progress in strengthening risk management practices.

... and in hedge fund counterparty risk management

As part of the ongoing dialogue with market participants, members exchanged views with representatives of the Institute of International Finance (IIF) on how regulation could be made more effective and efficient, and discussed ways to further enhance the dialogue between regulators and the financial industry. The Forum welcomed the IIF's efforts in this regard and recognised that financial services firms and regulators share a common view of the principles that underlie good regulatory practice. Noting the existing example of effective interaction discussed above, the FSF encouraged the IIF and other private market participants to raise issues of market weakness and other important regulatory issues that warrant the attention of regulators.

Stocktaking on standard-setting arrangements

With regard to international standard-setting practices, members took stock of the standard-setting arrangements employed by the key standard-

setting bodies (SSBs). Members felt that this stocktaking exercise would be useful to SSBs over time as they review their arrangements. The FSF welcomed the development of an Insolvency and Creditor Rights (ICR) Assessment Methodology by World Bank and UNCITRAL<sup>4</sup> staff. Members looked forward to the completion of a concise, unified ICR standard to help facilitate participation in the ROSC<sup>5</sup> process. Members agreed that the FSF should place on its website an overview by the FSF Secretariat of major international regulatory initiatives, and the timing of their implementation, in order to inform regulators and other stakeholders of what might be in the international regulatory pipeline so as to help avoid any potential bunching of initiatives.

The FSF also followed up on other ongoing concerns relating to business continuity, OFCs, and international accounting and auditing issues.

Regarding international cooperation between financial authorities in safeguarding business continuity in the event of an avian flu pandemic, members encouraged financial industry participants and authorities to make use of the Joint Forum's high-level principles for business continuity (see page 102). A workshop on planning and communication for financial crises and business continuity incidents would be hosted by the FSF and the UK authorities in November.

Further progress on business continuity ...

The FSF's OFC Review Group is continuing to monitor progress by FSF member bodies which are working with OFCs to improve cross-border cooperation and exchange of information. The FSF noted the progress made in some OFCs and urged its member bodies to continue their efforts, including monitoring the progress achieved to improve international cooperation, notably with IOSCO and the IMF.

... and in OFCs

Members reviewed recent international accounting and auditing developments. These included the need to achieve more consistent interpretations of International Financial Reporting Standards (IFRS), and the IASB's "standard-setting pause" under which no major changes to IFRS will become effective until 2009. They welcomed work on convergence and harmonisation under way between the IASB, the US FASB and other authorities. Members reiterated the important role that high financial accounting and reporting standards play in safeguarding financial stability, and expressed concern about some recent incidents that raised questions about the quality controls in place within global accounting firms. The concentration of audit services for large companies at the four largest audit firms was in any event also thought worrisome. Against this background, the FSF welcomed the proposal to create an International Forum of Independent Audit Regulators.

Review of recent international accounting and auditing developments

Drawing on the discussions at the meeting, the FSF chair *reported* to the International Monetary and Financial Committee and the G7 Ministers and Governors in Singapore on 16–17 September.

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<sup>4</sup> United Nations Commission on International Trade Law.

<sup>5</sup> Reports on the Observance of Standards and Codes.

Establishment of an  
International Forum  
of Independent  
Audit Regulators

Since September 2004, the FSF has encouraged national audit regulators to meet to exchange experiences and improve communication and coordination in ways that could enhance and bring more global consistency to audit oversight and audit quality. At a meeting of national audit regulators in Paris on 15 September 2006, an *International Forum of Independent Audit Regulators* (IFIAR) was established. Its objectives are: to share knowledge of the audit market environment and exchange practical experiences of independent audit regulatory activity; to promote collaboration in regulatory activity; and to provide a focus for contacts with other international organisations which have an interest in audit quality.

The meeting was attended by national audit regulators as well as international organisations and groupings, including the FSF. At the request of the audit regulators, the FSF provided assistance with the establishment of IFIAR and gave presentations at the meeting in support of IFIAR's audit quality objectives.