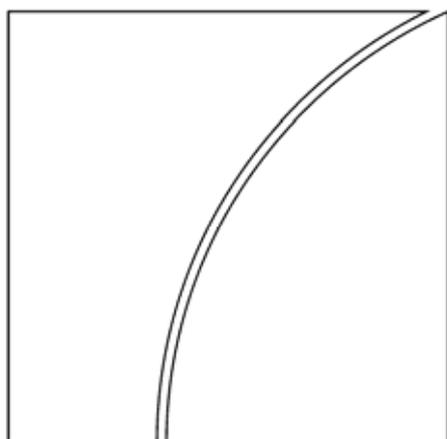


Basel Committee  
on Banking Supervision



**Report for the G7 Summit  
on the activities of the  
Basel Committee**

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# Report for the G7 Summit on the activities of the Basel Committee

## I. Executive Summary

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. It summarises the Committee's contribution to the promotion of stability in the global banking system through its efforts to provide guidance on key banking supervisory issues and foster cooperation among banking supervisors.

The publication in June 2004 of the Basel II Framework represented the outcome of a multi-year effort by the Committee to bring capital adequacy regulations, which are a key underpinning of the safety and soundness of the global banking system, up to date with current business realities and risk management practices. Currently, the Committee is actively promoting cooperation among supervisors with the goal of fostering greater convergence in supervisory practices in implementing the new rules.

In April 2006, the Committee published consultative papers on revisions to the *Basel Core Principles for Effective Banking Supervision* and to the associated *Core Principles Methodology*. The 1997 Core Principles and 1999 Methodologies, both produced in response to the call of the G7 Summit, have been used by countries around the world as a benchmark for assessing the quality of their supervisory systems and for identifying future work to be done to achieve a baseline level of sound supervisory practices. The revision, which addresses new issues, insights and gaps in regulation identified since 1997, will ensure the continued validity and usefulness of these important instruments. The Committee has conducted the review in close collaboration with the International Monetary Fund, the World Bank and major emerging market supervisors.

In addition, the Committee has revised its guidance on banks' corporate governance, actively engaged in a dialogue with accounting and auditing standard setters, and implemented several new initiatives to enhance the Committee's transparency and outreach. The Committee has been sensitive to the concern over regulatory overload and fully embraced the idea of a regulatory pause so that financial institutions can focus on implementation of the new Basel II Framework and of other international and national regulatory priorities. The Committee has continued to coordinate 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.

Section II of this report discusses ongoing work to achieve consistent and effective implementation of the Committee's revised capital framework. Sections III through V focus respectively on the Committee's revisions to the *Basel Core Principles for Effective Banking Supervision*, work on corporate governance, and work on accounting and auditing issues. Section VI looks at the Committee's work with the International Organization of Securities Commissions and the International Association of Insurance Supervisors under the aegis of the Joint Forum, while Section VII discusses recent improvements to the Committee's transparency and outreach practices. The concluding section lists the various policy papers released by the Committee over the past year.

## **II. The Revised Basel Capital Framework**

Over the past year, the Committee's efforts have focused on issues related to the implementation of the Basel II Framework, such as better coordination between home and host supervisory authorities. The fifth Quantitative Impact Study conducted by the Committee also marks a major milestone in the implementation of the Framework. The Committee has also extended the framework to better address risks arising from trading activities, for example, in the rapidly growing credit derivatives market.

### **Implementation Issues**

With the completion of the Basel II Framework, the Basel Committee has turned its attention to effective implementation of the Framework. Implementation is taking place through national legislative and/or regulatory processes, which may give rise to differences across jurisdictions that result from local market conditions and supervisory practices. The Committee is therefore working to encourage as much consistency as possible in the implementation of the Framework in order to reduce burden on supervisors and banks and minimise duplication of effort. The primary way in which this is achieved is through the Committee's Accord Implementation Group (AIG), which serves as a forum for sharing of information among supervisors.

The Committee has found that consistency in implementation is best achieved not through developing top-down rules, but rather by tailoring implementation plans to the unique circumstances of each banking organisation and its supervisors. In this regard, members of the AIG regularly share their experiences as home supervisors for some of the largest internationally active banks in the world. Members are engaged in practical outreach to host supervisors and to the banks themselves to establish clear lines of communication and cooperation in a pragmatic and effective manner.

To assist in these efforts, the AIG worked with supervisors from several non-Committee member countries to develop a paper on *Home-host information sharing for effective Basel II implementation*, which was published for comment in November 2005 and finalised in June 2006. This is part of a broader effort to ensure that implementation issues are discussed not only within the Committee, but also with supervisors outside of the Committee.

Finally, the AIG is working to promote greater consistency through sharing information in several key technical areas. For example, the AIG is exploring a range of issues related to the validation of banks' Basel II systems and processes. In that regard, the AIG has published several high-level, principles-based papers providing guidance on such topics as validation of portfolios that lack sufficient default data and the use of vendor products within banks' internal-ratings based systems. More detailed studies are being made available to bank supervisors on a global basis. The AIG is also actively sharing views on banks' assessment of operational risk, and last year published a paper on the treatment of expected losses in an advanced measurement approach.

### **Fifth Quantitative Impact Study**

To evaluate the effects of the Basel II Framework on overall capital levels, the fifth Quantitative Impact Study (QIS 5) was undertaken in all Basel Committee member countries except the US (which contributed with its QIS 4 data), and in 19 non-G10 countries, from October to December 2005. The primary objective of the study was to allow the Committee to review the calibration of the Basel II Framework; it also represents a major milestone in

the implementation of the Framework. In contrast to previous exercises, the QIS 5 workbooks reflect all recent changes to the Basel II Framework.

The Basel Committee reviewed and confirmed the calibration of the Basel II Framework in May 2006. The QIS results for the Basel Committee member countries show that minimum required capital under the Basel II Framework would decrease relative to the current Accord. For large, internationally active banks, minimum required capital would decrease by 6.8%, based on the results for the approach that participating banks will likely adopt after implementation. Taking into account the benign economic conditions prevailing in the final quarter of 2005 and the remaining uncertainties in the data, the Committee agreed that no adjustment of the scaling factor to credit risk-weighted assets would be necessary at this stage. The Committee intends to publish a detailed report on the outcome of QIS 5 in G10 and non-G10 countries in June 2006.

### **Application to Trading Activities**

In completing the Basel II Framework in 2004, the Committee determined that it was still necessary to establish capital requirements for certain exposures arising from trading activities, and for exposures to "double default" scenarios, where the risk of both a borrower and a guarantor defaulting on the same obligation may be substantially lower than the risk of only one of the parties defaulting. The Committee has worked jointly with the International Organization of Securities Commissions to consult with industry representatives and other supervisors to produce proposals on these matters. In July 2005, the Committee published *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects*. These rules will result in more risk-sensitive regulatory capital requirements for trading book exposures, including credit risk for over-the-counter derivatives, securities financing transactions and failed trades, as well as for double-default effects in both the banking and trading book. The Committee also recognises that in some cases national authorities may additionally decide to apply these rules to investment firms and to combined groups of banks and investment firms that are subject to prudential banking or securities regulation.

## **III. Basel Core Principles for Effective Banking Supervision**

On 6 April 2006 the Committee issued for a ten-week public comment an updated version of the 1997 Basel Core Principles and 1999 Methodology documents. The documents are slated for completion at the October 2006 International Conference of Banking Supervisors, with endorsement by senior supervisors from around the world.

The Basel Core Principles and its Methodology represent a global standard for efficient banking regulation and supervision that has been widely used by many countries as an overarching guideline for their supervisory frameworks. They have contributed to the overall strengthening of banking systems and, thus, have fostered financial stability. However, since 1997 major changes have occurred in financial systems and supervisory frameworks have also evolved significantly; in addition, the experience gathered in over one hundred Financial Sector Assessments conducted by the IMF and the World Bank, as well as self-assessments made by countries, have shown the need to update some aspects of the framework.

The review does not call into question the work carried out on the basis of the 1997 Principles, or indeed the planning of reforms on that basis. The number of changes incorporated has been limited to the minimum necessary to ensure its continued relevance as a flexible, globally applicable standard. The update has been achieved in association with the Core Principles Liaison Group, a consultative group that includes high-level banking

supervisors from sixteen non-Committee member countries. In addition, prior to the public consultation period, the Committee has gone through a consultation process with Regional Groups of Supervisors as well as with the standard setting bodies from other financial sectors.

#### **IV. Corporate Governance**

In the light of revised principles for corporate governance issued by the Organisation for Economic Co-operation and Development (OECD) in 2004, as well as a series of high-profile corporate governance breakdowns in recent years, some involving banks, the Committee decided to review its existing supervisory guidance on Enhancing corporate governance for banking organisations, which had originally been published in 1999. In the past year, the Committee revised this guidance. While largely consistent with the earlier version, the revised document highlights the roles of boards of directors (especially independent directors) and senior management, discusses in greater detail the importance of effective management of conflicts of interest, and introduces a discussion of the importance of governing in a transparent manner, especially where a bank operates in jurisdictions, or through structures, that may impede transparency.

#### **V. Accounting and Auditing**

The Committee's Accounting Task Force continues to promote efforts that support the Committee's strong interest in promoting sound and high quality accounting, disclosure, and auditing standards for the financial industry. Over the past year, the Accounting Task Force has focused on developing prudential reporting guidance and taking an active role in the development of international accounting and auditing standards through discussions with standard setters and comment letters. The Task Force continues to benefit from high-level dialogues with accounting and auditing standard setters and industry leaders. These discussions have assisted the Committee in heightening the standard setters' sensitivity toward supervisory concerns over accounting and auditing issues early in the standard development process.

During the past year, the Accounting Task Force developed guidance addressing prudential concerns for banks electing to adopt the recently issued International Accounting Standards Board (IASB) fair value option for valuing financial instruments. Additionally, a consultative paper was issued that provided draft guidance on sound credit risk assessment and valuation for loans, which addressed how common data and processes could be used for credit risk assessment, accounting, and capital adequacy purposes. Both of these documents were well received within the industry and are expected to be issued in final form during 2006.

#### **VI. Joint Forum**

The Joint Forum was established in 1996 under the aegis of the Basel Committee, the International Organization of Securities Commissions and the International Association of Insurance Supervisors to deal with issues common to the banking, securities and insurance sectors, including the regulation of financial conglomerates.

In December 2005 the Joint Forum published a consultation paper entitled *High-level principles for business continuity*. Its purpose is to provide a framework for the development by international standard setters and national authorities of business continuity arrangements that are broadly consistent but tailored to unique sectoral and local circumstances. More recently, two Joint Forum papers were published in May 2006. *The management of liquidity risk in financial groups* summarises the findings of a review of liquidity risk management practices among 40 large, complex financial groups with operations spanning national borders, financial sectors, and currencies. The second paper, *Regulatory and market differences: Issues and observations*, presents the results of a review of differences in regulatory approaches to the same type of risk across the banking, securities and insurance sectors.

The current work of the Joint Forum is focused in two areas: how financial institutions manage risk concentrations on a firm-wide basis, and how they manage customer suitability risk, particularly as it relates to the sale of retail financial products and services. Both workstreams are expected to be completed by the end of 2007.

## **VII. Basel Committee Transparency and Outreach**

The Committee has taken a number of steps aimed at promoting openness with non-member central banks and supervisory authorities. On the most senior level, the Committee has organised the biennial International Conference of Banking Supervisors (ICBS) for over 25 years. Senior supervisors from over 130 countries participated in the 2004 ICBS in Madrid, and the next conference is scheduled for October 2006 in Mexico. In addition, the Committee meets annually with the heads of regional supervisory groups: the most recent meeting was held in January 2006 and the next one is scheduled in October 2006. Also, the Committee's representatives attend and speak at most of the regional group meetings.

The Committee's Core Principles Liaison Group (CPLG) provides a forum for more frequent and direct non-G10 involvement in Committee work. The CPLG comprises supervisors from eight G10 and sixteen non-G10 jurisdictions as well as representatives of the IMF and the World Bank, and meets regularly to review key issues on the Committee's agenda. Most recently, the CPLG worked closely with the Committee members in the development of a consultative document on home-host information sharing for effective Basel II implementation. The Committee's Chairman has chaired part of some CPLG meetings, while the Committee held its first full joint meeting with the CPLG in July 2005 in Krakow, and plans to repeat this practice in the future.

In addition to involvement in the CPLG, representatives of a number of non-member jurisdictions participate in expert sub-groups of the Committee. Additionally, a drafting team consisting of an equal number of G10 and non-G10 representatives updated the Core Principles for Effective Banking Supervision and its accompanying Methodology.

Other fora exist for non-member jurisdictions to exchange information with the Committee and provide feedback on the Committee's work. For example, the Chair of the Committee's Accord Implementation Group meets with the CPLG's Working Group on Capital on a semi-annual basis. Furthermore, Committee members and the Secretariat often speak at events hosted by the Financial Stability Institute (FSI), which was founded jointly by the Committee and the BIS in 1999 to assist financial sector supervisors around the world in improving and strengthening their financial systems. FSI events provide additional opportunities for focused dialogue between Committee members and their high-level counterparts in non-member jurisdictions.

Over recent months, the Basel Committee has conducted a review of its transparency and outreach practices vis-à-vis both non-member supervisors and the industry. Based on the results of this review, the Committee has recently introduced a number of enhancements to its practices. Following its May 2006 meeting, the Committee began the practice of sharing meeting documents with the chairs of the regional supervisory groups as well as with non-G10 members of the Committee's Core Principles Liaison Group. The Committee is also constantly enhancing the quantity and quality of information available on its web site regarding its publications and the activities of its main working groups. Going forward, the Committee will also post comment letters received on most of its consultative papers. Lastly, the Committee will release its biennial report on international developments in banking supervision that until now has been confined to the supervisory community.

## VIII. 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](http://www.bis.org/bcbs)). The main publications and working papers issued by the Committee since June 2005 are listed below:

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### Documents published since the last G7 report

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| Date      | Title   |
|-----------|---|
| July 2005 | Enhancing corporate governance for banking organisations - consultative paper   |
| July 2005 | The Application of Basel II to Trading Activities and the Treatment of Double Default Effects   |
| July 2005 | Supervisory guidance on the use of the fair value option by banks under International Financial Reporting Standards -consultative paper |
| July 2005 | Guidance on the estimation of loss given default  |
| Sep 2005  | Validation of low-default portfolios in the Basel II Framework  |
| Nov 2005  | Sound credit risk assessment and valuation for loans  |
| Nov 2005  | Home-host information sharing for effective Basel II implementation - consultative paper  |
| Nov 2005  | The treatment of expected losses by banks using the AMA under the Basel II Framework  |
| Nov 2005  | Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework                                   |
| Nov 2005  | Amendment to the capital accord to incorporate market risks   |
| Dec 2005  | High-level principles for business continuity - consultative paper (Joint Forum)  |
| Feb 2006  | Enhancing corporate governance for banking organisations  |
| Mar 2006  | Use of vendor products in the Basel II IRB framework  |

|           |  |
|-----------|--|
| Apr 2006  | Core Principles for Effective Banking Supervision - consultative paper   |
| Apr 2006  | Core Principles Methodology - consultative paper                         |
| May 2006  | The management of liquidity risk in financial groups (Joint Forum)       |
| May 2006  | Regulatory and market differences: issues and observations (Joint Forum) |
| June 2006 | Home host information-sharing for effective Basel II implementation      |

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