

**Submission for the G-7 Heads of Government
at the 1998 Birmingham Summit**

**PROMOTING
FINANCIAL STABILITY**

**Recent Initiatives of the
Basle Committee on Banking Supervision**

**Basle
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Promoting financial stability

This report is intended to inform the G-7 Finance Ministers of the accomplishments and new initiatives of the Basle Committee on Banking Supervision over the past year related to promoting financial stability worldwide. The Committee has made significant progress in all of the key areas identified by Finance Ministers and initiated several new major projects related to strengthening banking supervision globally and to fostering relationships with both non-G-10 banking supervisors and supervisors of other financial activities. This work should contribute significantly to the G-7 initiative to improve global financial stability. The report also focuses on several of the efforts being conducted by the Committee's member institutions on a bilateral basis as well as those efforts being coordinated with other organisations such as the International Organisation of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank).

Since its establishment in 1974, the Basle Committee on Banking Supervision has provided a basis for international cooperation in banking supervision. The work of the Committee falls into three basic categories: (1) exchange of current information; (2) development and dissemination of sound supervisory practices; and (3) development and issuance of binding supervisory principles. This work consists of the essential elements of a sound international financial environment. Although originally established to develop closer contacts among banking supervisors from the G-10 countries and to strengthen their supervisory practices, the Basle Committee has in recent years increasingly intensified its relationships with banking and other supervisors in many countries and has promoted sound prudential standards worldwide. This is particularly evident in the Committee's continued support of the eleven regional supervisors' groups, which comprise approximately 135 countries and cover virtually all regions of the world, as well as its work through the Joint Forum.

Recent events in Asia demonstrate how important it is to continue to promote financial stability both in individual countries and globally. The Basle Committee is confident that standards and practices formulated and disseminated by the Committee in the past years

already provide solutions to many of the fundamental problems highlighted in Asia. Such key accomplishments as the formulation of the Core Principles for Effective Banking Supervision will address several areas of concern once they are fully implemented in individual countries.

Among the most significant accomplishments in the past year, the Committee has:

- Finalised the Core Principles for Effective Banking Supervision in cooperation with a large number of non-G-10 countries and developed a robust program to facilitate endorsement and implementation of the Core Principles by supervisors in the non-G-10 countries through liaison and technical assistance.
- Initiated, in conjunction with the Bank for International Settlements, the establishment of an institute for financial stability in Basle.
- Developed a practical framework for the supervisory evaluation of risk management and internal controls, applied it in key areas of market and interest rate risk, completed the development of supervisory capital standards for market risk, and continued work on market transparency and capital adequacy in light of rapid financial market evolution.
- Commenced a review of issues related to credit risk management, accounting and disclosure.
- Contributed, through the Joint Forum, to a framework for enhanced international information-sharing and cooperation in the supervision of financial conglomerates, published papers detailing the framework for consultation with supervisors and financial firms globally, and decided to proceed immediately with implementation and further elaboration of the framework.
- Provided leadership on supervisory issues related to the Year 2000 and the risk management of electronic money and electronic banking.

The following four sections describe in more detail the Basle Committee's continued efforts to promote financial stability worldwide. These sections correspond to the four priority areas identified at the Denver Summit: (1) improving prudential standards in emerging economies; (2) progress on current supervisory issues including risk management and market transparency; (3) international regulatory cooperation; and (4) electronic money.

I. Improving prudential standards in emerging economies

As events in Asia have demonstrated over the past several months, financial markets, both large and small, have become increasingly interdependent. In the crucial area of strengthening the financial sector in emerging market economies, the Basle Committee has reinforced its initiatives to intensify relationships with supervisors from, and improve banking practices in, the emerging economies. The single most important initiative of the Committee in this area has been the formulation of the Core Principles for Effective Banking Supervision, an endeavour that was undertaken with the support of banking supervisors from numerous non-G-10 countries who also recognise the need to strengthen prudential standards globally. The Committee draws the G-7 Finance Ministers' attention to the need to ensure that the preconditions for a sound financial system and for effective banking supervision set out in the Core Principles are adopted as quickly as possible in individual countries. The necessary changes may include, for example, developing basic legal and administrative frameworks.

The following summary of Basle Committee work in this area demonstrates the ongoing commitment of the Committee to working with non-G-10 supervisory authorities to improve prudential standards worldwide.

1. Strengthening banking supervision globally through the finalisation and wide-spread acceptance of the "Core Principles for Effective Banking Supervision" to be adopted and implemented worldwide

As highlighted in its report for the Denver Summit, the Basle Committee, in conjunction with numerous banking supervisors from non-G-10 countries, developed the Core Principles for Effective Banking Supervision. The twenty-five Principles set forth in the document are considered essential for a supervisory system in any country to be effective. The Principles are minimum requirements and, in many cases, they may well need to be strengthened or complemented to address particular conditions and risks in the local financial system.

Since the Committee believes that achieving consistency with the Core Principles in every country would be a significant step toward improving financial stability globally, it has been actively promoting adoption of the Core Principles over the past year. This has included emphasising the need in all countries, both inside and outside the G-10, for effective

implementation of the Principles. In addition, individual member countries have used the Core Principles as a basis for discussions with numerous non-G-10 countries. The Committee, both collectively and through its individual members, will continue to stress that the Core Principles must be implemented as quickly as possible and underscore the fact that banks from countries that do not take the necessary measures to implement the Core Principles may not be able to fully participate in international financial markets.

2. Promoting effective implementation of the Core Principles through the creation of a Core Principles Liaison Group and a Core Principles Consultation Group

The Committee has created two separate groups to help promote effective implementation of the Core Principles. Both groups are comprised of senior level supervisors from G-10 and non-G-10 countries. The Liaison Group has about twenty members, including representatives of the IMF and World Bank. It is the Committee's intention to utilise the Liaison Group to address issues arising from the implementation of the Core Principles in individual countries and to provide feedback to the Committee on what additional work may need to be done. The Group will benefit from the experience of the IMF and World Bank, both of which are utilising the Core Principles as a basis for judging the effectiveness of banking supervision in individual countries. Their assessment of where individual countries stand with regard to implementation and their views on what areas are particularly problematic will add to the discussions of the Liaison Group and any ensuing work. The first meeting of the Liaison Group is to be in mid-March 1998.

The much larger Core Principles Consultation Group has been created to allow for maximum participation and feedback by the non-G-10 countries. The Basle Committee believes that it is critical to build on the relationships fostered by the drafting of the Core Principles and to continue to have the necessary input from as broad a range of countries as feasible. While the Consultation Group will only meet annually, it will be involved in the work of the Liaison Group primarily through feedback and correspondence related to proposals and recommendations made by the Liaison Group.

3. Conducting a survey on the state of Core Principles implementation in individual countries

The Basle Committee has developed a survey not only to assess the state of implementation globally but also to enable the Committee to identify areas where further work by the Committee would assist non-G-10 countries in reaching full and meaningful compliance with the Core Principles. This survey will be conducted over the next several months and the results will be discussed at the International Conference of Banking Supervisors in October 1998 (see Section III.3 below) and at future Basle Committee meetings.

4. Taking the initiative, together with the Bank for International Settlements, to establish an institute for financial stability in Basle

The Basle Committee and the Bank for International Settlements have decided to establish an institute for financial stability at the Bank for International Settlements in Basle. The Institute, which is expected to be established at year-end, will expand on the technical assistance that the Basle Committee has already been providing for both G-10 and non-G-10 supervisory authorities. It will respond to ever-increasing demands for advanced training and assistance in implementing sound supervisory principles within the banking, securities and insurance sectors. The Institute will provide courses both in Basle and in the field. It will also help coordinate bilateral assistance provided by Basle Committee members and others.

5. Increased training initiatives conducted over the past year

The Basle Committee remains committed to actively providing necessary training to supervisors from both G-10 and non-G-10 countries. Over the past few years, the Committee has devoted significantly increased resources to training through the Committee's Secretariat. For example, whereas in 1994 the Committee organised three training sessions attended by a total of 86 participants, in 1997 it held eleven training sessions attended by a total of 412 participants. These training sessions were held in locations around the world and focused on a broad range of supervisory topics. The Committee also continues to collaborate with the IMF, World Bank and others on training programmes for banking supervisors.

For 1998, the Committee has reinforced its commitment to training in light of the implementation of the Core Principles and the ongoing need to strengthen supervisory standards and practices in emerging market economies, as underscored by the recent turmoil in Asia. Going forward, the Committee's training initiatives will be reinforced by the Institute mentioned in Section I.4. above.

6. Initiating and organising meetings with non-G-10 supervisors to enhance cooperation and information exchanges among individual supervisors

In addition to forming the Core Principles Liaison and Consultation Groups, the Basle Committee initiated and organised several meetings with non-G-10 supervisors over the past year. These meetings allowed for the continuation of a dialogue among the various supervisors on issues of common concern. Several of these meetings focused, *inter alia*, on the Core Principles for Effective Banking Supervision and provided the non-G-10 supervisors an opportunity to express ways in which the Committee could help foster adoption and implementation of the Core Principles.

7. Continued dissemination of Basle Committee products throughout the international supervisory community

The Basle Committee has a long history of making its work public and encouraging the improvement of banking supervision techniques through the dissemination of its products. These products are distributed both in the form of individual papers, as they are released, and in the form of a three-part "Compendium of documents produced by the Basle Committee on Banking Supervision". The Committee continues to involve the non-G-10 countries, as well as individual market participants and related trade associations, in the drafting of many individual documents through the public consultation process. By providing a broad distribution for its work, the Basle Committee is facilitating the use of such work by non-G-10 countries in improving banking practices and banking supervision.

The Compendium serves as a supplement to the Core Principles in that the documents contained therein provide more detailed guidance on numerous specialised topics. The Committee will update the Compendium periodically.

8. Bilateral initiatives by member countries including enforcement of the Minimum Standards, training and other forms of support

The member countries of the Basle Committee continue to support on an individual basis the initiatives of the Committee to improve financial stability globally. Each member country is committed to enforcing the "Minimum Standards" for the supervision of international banking groups and their cross-border establishments. In addition, the member countries have continued their efforts to reduce impediments to the sharing of information among supervisory authorities. Other efforts include the provision of bilateral technical assistance and making available qualified lecturers for training programs as described in Section I.5. above.

II. Progress on current supervisory issues including risk management and market transparency

The Basle Committee continuously monitors existing practices and emerging issues in banking and finance in order to be in a position to adapt banking supervisory methods and requirements to current needs. Promotion of international banking soundness is primarily achieved through the fostering of strong individual banking institutions and adequate monitoring by the banking supervisory agencies. The Committee is therefore committed to establishing and enforcing sound banking and supervisory practices in its member countries and encouraging non-G-10 countries to apply similar standards to their banking institutions.

Following is a summary of the most significant initiatives of the Committee in this area over the past year. It should be noted that many of these initiatives address aspects of the problems currently highlighted by the financial turmoil in Asia.

1. Development of guidance on risk management, collateral management, asset securitisation, credit derivatives, operational risk and bank audits

The topic of risk management is broad and one that currently is getting a great deal of attention. The Basle Committee has worked to improve the management of risk at individual banking organisations and has emphasised that sound risk management is essential

to the prudent operations of banks and to promoting stability in the financial system as a whole. To further this work, the Basle Committee is now in the process of developing principles on risk management with a view to underscoring the basic elements of a sound risk management process that must be applied to any activities conducted by a bank.

One of the most important areas of risk for banks globally is that related to extensions of credit. Recent events demonstrate the importance of sound credit infrastructures at banks to the stability of global financial systems. The Committee has therefore commenced a review of issues related to credit risk management and intends to develop further guidance on this topic. This guidance will include a basic framework of sound practices for traditional commercial credit risk management and will also address issues related to credit-related accounting and disclosure. Work has also commenced on the specific issues of collateral management, asset securitisation and credit derivatives and the Committee is working with the industry to take stock of current developments in the area of credit risk modelling.

There is currently intense interest in the financial community regarding new approaches to measuring, monitoring and controlling operational risks and to managing internal audit activities to better assess and strengthen internal controls. Consequently, the Committee has initiated studies related to these topics.

2. Release of a practical framework for the evaluation of internal control systems utilised by banks

The Basle Committee has taken measures to emphasise the need for banks to maintain adequate internal control systems over their entire operations through the release of a practical framework for the evaluation of such systems by banking supervisors. This framework was issued in January for comment and it is anticipated that it will be issued in final form by mid-year. The framework underscores the fact that a system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banking organisations. The objective of the document is to outline a number of principles for use by supervisory authorities when evaluating banks' internal control systems. The principles relate to management oversight, risk assessment, control activities, information and communication, monitoring, and evaluation of internal control systems by supervisory authorities.

3. Emphasising the need for strong corporate governance

The Basle Committee is committed to strengthening the corporate governance of banks. The Committee will shortly issue a paper that clarifies the role and responsibilities of boards of directors and senior management, stresses the need to avoid conflicts of interest (including inappropriate connected lending) and describes several organisational structures that can be adopted in order to promote strong corporate governance.

4. Agreement on principles for the management of interest rate risk

After a consultation period, the Committee issued in September 1997 a set of principles for the management of interest rate risk. The eleven principles and supporting text are intended for use by banking supervisors in evaluating the effectiveness of banks' management of interest rate risk. The principles encompass oversight by the board of directors and senior management, adequate policies and procedures for managing interest rate risk, systems for measurement and monitoring of such risk, comprehensive controls, and the methods to be used by supervisors to monitor interest rate risk. The Committee believes that this guidance will provide critical assistance to all supervisors seeking to improve interest rate risk management by banks in their countries.

5. Pursuing initiatives to enhance market transparency through increased disclosure by banks and other financial market participants

The Basle Committee recognises that market mechanisms can reinforce supervisory efforts to promote safe and sound banking systems by rewarding banks that manage their risks well and penalising those that have inept or imprudent risk management. Market discipline can only work if market participants have access to timely and reliable information. As part of its continued efforts to encourage banks to provide market participants with sufficient information to understand the risks inherent in their trading and derivatives activities, the Basle Committee, in cooperation with the technical committee of IOSCO, has published for the third time a survey with recommendations about the disclosures that should be provided related to these activities. This survey revealed substantial progress in disclosure practices related to market risks, although there were still some discrepancies across institutions and countries. The Committee has carried out extensive work to monitor and

review disclosure practices more broadly with a view to identifying activities and risks where further supervisory guidance would be useful. Currently, the Committee is considering issuing guidance to market participants and supervisors in both the G-10 and non-G-10 countries to address reporting and disclosure issues.

6. Addressing issues in the area of bank accounting including work on accounting for loans and loan impairment

The Committee has done considerable work related to surveying current bank accounting principles and practices in its member countries. This work will enable the Committee to identify issues where the content and quality of accounting standards differ among countries. As a follow-up to this work, the Committee has recently initiated review of supervisory guidance regarding loan valuation, credit loss provisions and related matters.

The Basle Committee is also closely following and reacting to work on the development and improvement of international accounting standards carried out by the International Accounting Standards Committee (IASC). It is the intention of the Committee to contribute to and influence these processes as they relate to banks.

7. Ongoing monitoring of the Basle Capital Accord and various initiatives to address issues related to bank capital adequacy

Capital requirements are an essential supervisory tool for fostering safety and soundness of banks. The Basle Committee has continued to take the lead in developing and monitoring capital adequacy standards. A central mission of the Committee is to ensure that the Basle Capital Accord keeps pace with the rapid evolution in the marketplace and remains an effective and relevant international standard.

The issuance of new capital instruments and improved techniques for measuring, trading, and hedging risks are important financial market developments that have implications for assessing bank capitalisation and risk levels. The Committee is currently assessing the necessary characteristics and principles that capital instruments should meet for inclusion in the regulatory capital base. The Committee is also studying new techniques for laying off risk and for measuring and modelling credit risk. As part of this effort, the Committee is evaluating whether these new techniques might be factored into existing capital requirements.

8. Adoption of the market risk amendments to the Basle Capital Accord requiring banks with open positions to hold capital against these positions

As mentioned in its report for the Denver Summit, the Basle Committee has amended its 1988 Capital Accord to incorporate market risks. The Amendment is designed to ensure that banks hold a prudent level of capital against risks associated with their trading activities and to reinforce banks' efforts to improve risk management techniques vis-à-vis their overall market activities. The Amendment came into force at the beginning of the year and the Committee is overseeing its implementation.

9. Taking the lead in stressing the need for financial sector preparedness for the Year 2000

The Basle Committee has taken a leadership role in raising worldwide awareness of this critical issue. In September 1997, the Committee issued a paper entitled "The Year 2000: A Challenge for Financial Institutions and Bank Supervisors" and subsequently formed a Year 2000 Task Force to monitor efforts globally and to provide guidance on issues of concern with respect to the Year 2000. The Task Force conducted a survey of the state of preparedness in the G-10 countries as well as in numerous non-G-10 countries. The results of the survey have helped the Committee determine what additional guidance needs to be issued. This guidance is currently under development and will be issued shortly. The survey also provided an important reminder to supervisors worldwide that this issue needs immediate attention and highlighted the many areas of preparedness for which they should be checking.

The Committee is also co-sponsoring a conference to be held in April 1998 to further discussion on this topic and to suggest solutions to common problems.

III. International regulatory cooperation

As mentioned above, the Basle Committee has a long tradition of taking a leadership role in increasing international regulatory cooperation, both among the G-10 and non-G-10 banking supervisors as well as with supervisors of other financial activities. This commitment to international regulatory cooperation is demonstrated by the following initiatives taken since the report submitted for the Denver Summit.

1. Strengthening relationships with supervisors from non-G-10 countries through establishment of Core Principles Liaison and Consultation Groups

As set out in Section I.2. above, the Basle Committee has recently established two groups to encourage effective implementation of the Core Principles for Effective Banking Supervision. The Committee is confident that these two groups will continue to foster its already strong relationships with banking supervisors from non-G-10 countries.

2. Enhancement of international regulatory cooperation through active participation in the Joint Forum on Financial Conglomerates

In addition to its work with banking supervisors from non-G-10 countries, the Basle Committee continues to act as a leader in strengthening cooperation among regulators of financial market participants. Much of the work in this area is done through the Joint Forum on Financial Conglomerates composed of members of the Basle Committee, IOSCO and the IAIS. The Joint Forum provides a mechanism for supervisors of the banking, securities and insurance industries to build and maintain the cooperative relationships necessary to address the challenges arising from international financial conglomerates. It also facilitates the smooth functioning of channels of communication between supervisors on both an ongoing basis and during emergencies. The Basle Committee, together with IOSCO and the IAIS, is submitting a separate, more detailed report prepared by the Joint Forum.

The Basle Committee, along with IOSCO and the IAIS, is currently undertaking the consultation of several papers prepared by the Joint Forum on various aspects of the supervision of financial conglomerates. These papers are, in part, the result of an ambitious study of the structures and functioning of over a dozen large international financial conglomerates. This extensive effort provided valuable insight into the implications of different structures on supervisory matters and, in particular, on supervisory information requirements.

The papers currently out for consultation address such issues as capital adequacy measurement techniques on a group-wide basis, the soundness of management, supervisory information sharing between supervisors and impediments thereto, and the coordination of supervisors' efforts. Some of the papers released (for example, the Conglomerate and Supervisory Questionnaires) are tools for the use of supervisors in enhancing their

understanding of the organisational structures and the functioning of diversified financial groups.

The initiation of a consultative process is the culmination of intensive efforts by the Joint Forum and supervisors in each of the three sectors over the past year. It is also the first step in the process of beginning practical work to implement the principles and guidance elaborated to date, thereby enhancing the cooperation that already exists between supervisors, particularly intra-sector. The Basle Committee is committed to continuing its support of and leadership in Joint Forum initiatives and to increasing its cooperative efforts trans-sectorally.

The Basle Committee also actively participates in the Coordinating Committee, which is comprised of representatives of the Basle Committee, IOSCO and the IAIS. The Coordinating Committee meets periodically to review joint work in progress and to exchange information on the individual agendas and projects of the three groups.

3. Sponsorship and organisation of the October 1998 International Conference of Banking Supervisors to be attended by over 130 countries

The International Conference of Banking Supervisors (ICBS), a biennial meeting of banking supervisors from around the world, was initiated by the Basle Committee in 1979. Since that time, the ICBS has provided a regular forum that allows banking supervisors to meet and discuss supervisory issues of mutual concern. The conference also fosters the strengthening of relationships between supervisors from different countries, a key element in managing banking crises. For this reason, the Basle Committee continues this tradition by dedicating the necessary resources to organise such a conference. The tenth ICBS will be hosted by the Reserve Bank of Australia in Sydney in October of this year.

4. Continuing commitment to increasing cooperation with non-G-10 regional supervisory groups through participation in their meetings leading to increased exchanges of views and experiences

The Basle Committee continues to support the regional supervisory groups, currently numbering eleven, through participation in their annual meetings. This participation encourages the non-G-10 supervisors attending such meetings to stay current on and provide

input to the work of the Basle Committee, promotes the strengthening of supervisory policies in the region, and fosters the sharing of necessary information.

5. Ensuring efficient communication channels through maintenance and regular distribution of the “Bank Supervisors’ Contact List”

The Bank Supervisors’ Contact List, maintained by the Committee Secretariat, contains the names, addresses, and phone and fax numbers of key contacts at the banking supervisory agencies in individual countries. This list is a critical resource document for supervisors, not only in times of banking system stress (as recently demonstrated in several problem cases) but also as a tool in facilitating global supervisory contacts. This list is distributed not only to banking supervisors but also to IOSCO and the IAIS.

6. Bilateral initiatives by member countries, including the extensive use of memoranda of understanding, to strengthen supervisory contacts globally, enhance cooperation among supervisory agencies, and promote information exchanges

The banking supervisory agencies represented on the Basle Committee have individually taken steps to foster international regulatory cooperation through a number of channels. These include the development of bilateral memoranda of understanding between the member country and individual G-10 and non-G-10 countries. Such memoranda of understanding enhance cooperation and promote information exchanges by setting out pre-arranged courses of action. By formalising bilateral supervisory cooperation, the member countries have sought to improve working relationships and cooperation.

IV. Electronic money

Although not solely within the purview of banking supervisors, the development of electronic money and electronic banking inevitably has an impact on banking safety and soundness. As mentioned in the report for last year’s Summit in Denver, the Basle Committee established a working group to look into issues related to electronic money and electronic

banking and to determine what initiatives the Committee should pursue. In the past year, the Committee has addressed some of these issues in the following ways.

1. Sponsorship and organisation of a workshop on banking technology issues (including electronic money) held in Rome in June 1997

In recognition of the impact that technology is having on banking activities, the Basle Committee sponsored and organised a workshop on banking technology issues last June. This workshop was attended by the G-10 countries as well as numerous non-G-10 countries where the domestic markets are currently sophisticated enough to be dealing with issues related to banking technology. The conference covered several topics including current developments in technology and their impact on the financial services industry, the effect of such technology on the costs of providing financial services, outsourcing of banking services and the challenges faced by supervisors. The workshop provided an opportunity for banking supervisors to hear from industry experts and to share ideas on how to meet the challenges posed by developments in the area of banking technology.

2. Issuance of a paper for use by banking supervisors and industry practitioners on risk management of electronic banking and electronic money activities

As mentioned in the report submitted for the Denver Summit, the Basle Committee has been analysing issues related to electronic banking and electronic money. The Committee has issued a paper entitled "Risk Management for Electronic Banking and Electronic Money Activities". This document consists of a broad discussion of the risks inherent in electronic banking and electronic money activities and a basic framework for risk management and internal controls. The Committee believes that, although these activities are still in their early stages, the publication of such a document will facilitate the further development of a prudent supervisory approach globally. After publication of the document, the Committee intends to initiate a dialogue with the industry in order to survey the methods currently being utilised by banks to manage the different risks arising from their electronic banking and electronic money activities.