

Promoting Financial Stability

March 1999

**Submission for the G-7 Heads of Government
at the 1999 Köln Summit**

PROMOTING FINANCIAL STABILITY

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

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This report has been prepared in order to inform the G-7 Finance Ministers of the continuing efforts of the Basle Committee on Banking Supervision to promote financial stability worldwide. The report sets out the Committee's principal activities and accomplishments, including follow-up of earlier initiatives and development of new initiatives, since the report submitted for the 1998 Birmingham Summit.

The Committee continues to make significant progress in several key areas identified by Finance Ministers as important to improving financial stability globally. The Committee has reinforced its efforts on numerous projects begun over the past few years and initiated several new projects related to strengthening banking supervision worldwide 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 some of the efforts being coordinated with other organisations such as IOSCO, the IAIS, the IMF and the World Bank.

Recent events continue to demonstrate that work needs to be done to promote financial stability both in individual countries and globally. The Basle Committee remains committed to the efforts initiated over the last few years and is confident that standards and practices formulated and disseminated by the Committee in the past already provide solutions to many of the fundamental problems highlighted in several emerging market countries. Such key accomplishments as the formulation of the Core Principles for Effective Banking Supervision will address several areas of concern once they have been fully implemented and had time to take effect in individual countries.

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

- continued to foster full implementation in individual countries of the Core Principles for Effective Banking Supervision through liaison and training, in cooperation with the Core Principles Liaison Group, the IMF and the World Bank;
- conducted a thorough review of the Basle Capital Accord and initiated the preparation of a consultative paper proposing fundamental changes;
- issued a report analysing banks' interactions with highly leveraged institutions together with guidance on sound practices in such dealings;
- developed a set of proposed sound practices for the valuation of loans, the establishment of loan loss allowances, credit risk disclosure and related matters;

- continued work on promoting enhanced transparency of banks' activities and risks, including having issued papers on enhancing bank transparency and a supervisory information framework, and developed recommendations on trading and derivatives disclosure and credit risk disclosure;
- developed a practical framework for the supervisory evaluation of internal controls and credit risk management, and addressed operational risk in light of financial market evolution;
- provided leadership on supervisory issues related to Year 2000; and
- continued work through the Joint Forum on a framework for enhanced international information-sharing and cooperation in the supervision of financial conglomerates.

The information in the following sections specifically addresses such priority areas identified by the G-7 Finance Ministers as: strengthening national financial systems, revising the Basle Capital Accord, enhancing transparency, and addressing the Year 2000 situation. These initiatives illustrate the Basle Committee's continuing efforts to promote financial stability worldwide.

As proposed by the G-7 Finance Ministers and Central Bank Governors, the Basle Committee has also commenced work on a more comprehensive review of a number of International Accounting Standards to determine their acceptability from the point of view of banking supervisors' objectives of prudent bank supervision and enhanced transparency. The Committee will report back to the G-7 Finance Ministers and the International Accounting Standards Committee in the second half of 1999.

I. Improving prudential standards in emerging economies

As events in Asia, Russia and Brazil have demonstrated, 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 continues its initiatives to intensify relationships with supervisors from, and improve banking practices in, the emerging economies. The single most important recent initiative of the Committee in this area has been the formulation of the Core Principles for Effective Banking Supervision, which were issued in September 1997. The Committee remains committed to assisting in the implementation of these Principles worldwide. As was done last year, the Committee draws the G-7 Finance Ministers' attention to the need to ensure 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 include, for example, passage of legislation and amendments to administrative practices.

Going forward, the Basle Committee expects to play a role in the work of the recently established Financial Stability Forum. The Basle Committee's Chairman, Mr. William McDonough, will serve on the Forum as well as be a member of the Chairman's Committee. One additional member of the Basle Committee will also serve on the Forum.

1. Promoting effective implementation of the Core Principles in non-G-10 countries through the creation of a Core Principles Liaison Group, a Core Principles Consultation Group and collaborative efforts with the IMF and World Bank

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, which meets quarterly, has about twenty members, including representatives of the IMF and World Bank. The Committee is utilising 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 is benefiting 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 add to the discussions of the Liaison Group and any ensuing work. In recognition of the fact that the Basle Capital Accord has been adopted worldwide, the Committee has sought and received a report from the non-G-10 members of the Liaison Group on their experiences in implementing the Accord and on possible revisions. Going forward, the Liaison Group will also be involved in testing exercises related to any proposed revisions.

The much larger Core Principles Consultation Group was 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 only meets annually (its first meeting took place in October 1998), it is involved in the work of the Liaison Group primarily through feedback and correspondence related to proposals and recommendations made by the Liaison Group.

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

In preparation for the International Conference of Banking Supervisors in October 1998 (see Section V.3 below), the Basle Committee conducted a survey to assess the state of implementation globally of the Core Principles and 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. Responses were received from more than 120 countries. The results of the survey were discussed at the ICBS and at subsequent Basle Committee and Liaison Group meetings.

The survey provided the incentive for supervisors in all countries to review their current supervisory policies, practices and procedures and to conduct an assessment of the state of banking supervision in their country. The results indicated areas where there is broad implementation as well as areas where considerable work still needs to be done in numerous countries. The survey was conducted at a time when very significant changes are occurring in a large number of supervisory systems, including the passage of new banking legislation or amendments to existing regulations, supervisory structure changes, and in-depth reviews and revisions to current supervisory policies and procedures. In many instances, respondents indicated that the changes they are making will result in important improvements to their current supervisory programs.

3. Creating a Core Principles Methodology Working Group to prepare more detailed criteria for judging the implementation of the Core Principles in individual countries

The Core Principles Survey (see item I.2. above), as well as recent work done by the IMF and World Bank, has underscored the need to develop more specific criteria by which to judge the level of implementation of the Core Principles in individual countries. The Basle Committee recently formed a small group of experts, comprised of representatives from five member institutions, the IMF and the World Bank, to develop a detailed and harmonised methodology for assessing compliance of individual countries. The group is developing relevant criteria for each of the Principles. The methodology document will also include, as an attachment, the report format agreed between the IMF and World Bank for their ongoing work in assessing compliance with the Core Principles in their member and client countries.

Along with the Basle Committee, the Core Principles Liaison Group has also been actively involved in providing advice and feedback to the working group on this project. This will ensure that the views and experiences of non-G-10 countries are adequately reflected in the methodology.

4. Taking the initiative, together with the Bank for International Settlements, to establish the Financial Stability Institute in Basle and continuing to expand the Committee's training initiatives, particularly for supervisors in emerging markets

The Basle Committee and the Bank for International Settlements decided in 1998 to establish the Financial Stability Institute at the Bank for International Settlements in Basle. The Institute, which is currently developing a range of courses and conferences, 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.

The Basle Committee remains committed to 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. This has included providing speakers and lecturers for a wide variety of workshops, seminars and conferences. 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.

During 1998, the Committee 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. Going forward, the Committee's training initiatives will be reinforced by the Institute.

5. 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 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.

6. Revising and re-issuing the comprehensive Compendium of Basle Committee documents

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 papers. These papers are distributed both as they are released, and as part of a three-part "Compendium of documents produced by the Basle Committee on Banking Supervision". 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, which is now more than 750 pages long, serves as a supplement to the Core Principles in that the documents contained therein provide more detailed guidance on numerous specialised topics. The Committee is updating the Compendium periodically.

7. Developing Basle Committee guidelines and recommendations on various topics covered by the Core Principles that have not previously been addressed

In order to provide a full range of documents to support each of the Core Principles, the Committee has developed papers on various topics such as credit risk management, internal controls, and accounting for loans (see in particular Sections III and IV below). These documents are included in the periodic revisions to the Compendium and made available on the BIS Website as they are finalised.

II. Revisions to the Basle Capital Accord

Capital requirements are an essential supervisory tool for fostering the safety and soundness of banks. Since adoption of the Basle Capital Accord in July 1988, 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 Accord keeps pace with the rapid evolution in the marketplace and remains an effective and relevant international standard.

The Basle Capital Accord has now been in existence for more than ten years. The Accord has served supervisors and the financial system well during this time. However, rapid evolution in the financial industry has exposed some weaknesses in the Accord. Perhaps the most significant of these is the limited ability of the Accord to assess capital adequacy in

relation to a bank's true risk profile. In particular, the Accord is restricted in taking into account gradations in credit risk. In some instances, this has produced incentives for banks to restructure transactions or instruments to take advantage of regulatory capital arbitrage opportunities.

In mid-1998, the Basle Committee began a major effort to revise the Accord. The goal is to develop a capital adequacy framework that will continue to serve as an effective supervisory tool and is responsive to the continually evolving financial services industry.

The objectives in revising the Accord have been identified as:

- continued promotion of safety and soundness in the financial system
- enhancement of competitive equality
- constitution of a more comprehensive approach to addressing risks
- continued focus on internationally active banks, while ensuring that the Accord's underlying principles are suitable for application to banks of varying levels of complexity and sophistication.

As a means of achieving these objectives, the Committee is committed to developing a framework that will require banks to meet a minimum capital requirement, but also will require them to make a careful assessment of capital adequacy in relation to their individual risk profiles. The revised Accord will place a strong emphasis on the supervisory review process and market discipline as complementary to capital adequacy requirements in ensuring safety and soundness.

The Committee recognises that a substantial overhaul of the Capital Accord will likely take several years. The need for such time reflects the current state of the art of credit and operational risk measurement. Both are evolving rapidly, with credit risk well ahead of operational risk, but neither is as developed as market risk. The Committee will want to ensure that a substantial revision of the Capital Accord, at a minimum, maintains the amount of capital in the banking system. Finally, the move to a substantially revised capital framework has resource implications which the Committee is just starting to study. For these reasons, the Committee has decided to undertake a multi-track approach.

In order to deal with the short-term issues, the Committee is working on a consultative document for modifying the present standardised approach in the Accord, which would redress the critical shortcomings in the Accord. Among other issues, the Committee is looking into the possibility of expanding the number of risk buckets, using external credit ratings to some extent, and introducing a capital charge for other types of risk besides credit and market risk, namely operational risk.

The Committee believes that the objective of more closely aligning capital charges to underlying risk can be met in varying ways, depending on the timeframe under consideration and on the technical abilities of banks and supervisors. Thus, in addition to its efforts to review the standardised approach, the Committee will be analysing the potential use of internal credit-risk ratings by sophisticated banks as the basis for a capital charge.

The Committee has also analysed the use of credit risk modelling techniques by some banks to quantify and manage their portfolio credit risk, and will be issuing shortly a paper *Credit risk modelling: current practices and applications* that highlights its findings. The Committee notes that such models have the potential to improve banks' risk management systems, and recognises their use by some supervisors in making appraisals. However, a number of obstacles, including data availability and model validation, must be overcome before credit risk models can be used in setting regulatory capital. The Committee hopes that this will be possible after further development and testing, and intends to monitor closely progress on these issues.

III. Continued work to promote enhanced transparency

In recognition of the fact that market mechanisms can reinforce supervisory efforts to promote safe and sound banking systems, the Basle Committee continues its work to promote enhanced transparency in national and international banking systems. Such transparency is critical to market discipline, which can only work effectively if market participants have access to timely and reliable information that enables them to adequately assess a bank's activities and the risks inherent in those activities. Therefore, transparency is key to a safe, sound and effectively supervised banking system. Following is a summary of the most significant initiatives of the Committee in this area over the past year.

1. Publication of a paper on enhancing bank transparency

In September 1998, the Basle Committee issued a paper *Enhancing Bank Transparency* discussing ways to strengthen market discipline by enhancing banks' disclosure of key information regarding their activities. The paper highlights the critical role of public disclosure in effective market discipline and provides guidance on disclosure. Specifically, the paper recommends that banks make meaningful public disclosure in six broad areas: financial performance; financial position (including capital, solvency and liquidity); risk management strategies and practices; risk exposures (including credit, market, liquidity, operational, legal and other risks); accounting policies; and basic business, management and corporate governance information. The paper also notes that the first priority of supervisors in countries with less developed financial markets must be to establish a comprehensive supervisory

reporting system. All supervisors are encouraged to have access to information discussed in the report and other information of supervisory interest.

2. Revision to the Supervisory Information Framework on derivatives and trading activities

Also in September 1998, the Basle Committee, in collaboration with the Technical Committee of IOSCO, issued an amendment to the Supervisory Information Framework on derivatives and trading activities. The amendment incorporated market risk reporting requirements. The framework provides guidance on information that supervisors should collect about derivatives and trading activities, and has been widely implemented by banking and securities supervisors.

3. Issuance of the annual Trading and Derivatives Disclosure Survey Report

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 published at the end of 1998, in cooperation with the Technical Committee of IOSCO, the fourth annual survey report on the public disclosure of trading and derivatives activities of large, internationally active banks and securities firms headquartered in the G-10 countries.

As with the three previous reports, the survey report provides a picture of the advances in disclosure practices of banks and securities firms for trading and derivatives activities and encourages such institutions to further enhance their disclosures.

4. Development of recommendations on trading and derivatives disclosure

The Basle Committee, in collaboration with the Technical Committee of IOSCO, recently issued a consultative paper setting out recommendations for banks and securities firms on the disclosure of information on their trading and derivatives activities. These recommendations complement the survey work mentioned in point III.3 above. They replace guidance issued by the Basle Committee and IOSCO in 1995 to take account of developments that have occurred since that time.

5. Development of recommendations on credit risk disclosure

The Basle Committee conducted a fact-finding survey on credit risk disclosure practices at banks. It is currently in the process of interviewing rating agencies, market participants and other key information users to better identify their information needs. It is the intention of the Committee to prepare a consultative paper containing credit risk disclosure guidance in the first half of 1999.

IV. Progress on current supervisory issues including risk management

As part of its ongoing work, the Basle Committee continuously monitors existing practices and emerging issues in banking and finance in order to be in a position to advise on sound banking supervisory methods. 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.

1. Finalisation and 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 1998 for comment and in final form in September 1998. 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.

2. Development of guidance on sound practices for banks' dealings with highly leveraged institutions

In October 1998, following the near-collapse of Long Term Capital Management (LTCM), the Basle Committee established a small working group to study banks' interaction

with highly-leveraged institutions (HLIs) such as hedge funds, particularly in light of recent experiences. The working group analysed the risks posed by HLIs both to direct creditors and, under certain market conditions, to the financial system as a whole. This analysis addressed the deficiencies in risk management practices at some banking organisations with respect to their interaction with HLIs and evaluated various potential supervisory and regulatory responses to such risks.

At the end of January 1999, the Basle Committee issued a report *Banks' Interactions with Highly Leveraged Institutions*. The report consists of three principal parts: (1) a description of the characteristics of HLIs and an explanation of the nature of banks' interactions with them; (2) an assessment of the quality of banks' risk management practices with respect to HLIs; and (3) a discussion of possible supervisory and regulatory responses with respect to the weaknesses identified. At the same time, the Committee issued a related paper *Sound Practices for Banks' Interactions with Highly Leveraged Institutions*. This paper encourages the further development of prudent approaches for the assessment, measurement and risk management of credit exposures to HLIs, and the continuation of the improvements that have already been put in place by many banks since the LTCM incident. The Committee believes that both papers will be useful to supervisors and bank management seeking to enhance risk management practices.

In addition to the promotion of sound practices, the Committee also considered the desirability and feasibility of a number of other regulatory and supervisory measures. These included efforts to enhance transparency and direct regulation of HLIs. With respect to direct regulation, the Committee noted that assessment of the related costs, benefits, and effectiveness of such measures would require a comprehensive review of the potential impact on financial markets and market participants. Such measures would also extend beyond the sole purview of bank supervisors, and would require broader coordination with other parties. The Committee also emphasised that many of the systemic risks associated with the activities of HLIs can be addressed through better risk management at the counterparty level.

With respect to transparency, one possibility that was considered was whether the concept of a credit register for bank loans could be extended to the HLI context. Such an initiative, if appropriately designed, could contribute to filling information gaps, for both banks, supervisors, and third-parties in respect of dealings with HLIs; however, it also raises feasibility issues. The Basle Committee will continue to closely follow the work of the Committee on the Global Financial System on this issue, as part of the latter group's efforts to evaluate means for improving disclosure in the financial system as a whole.

3. Development of guidance on credit risk management, collateral management, asset securitisation, and credit derivatives

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 been conducting work on issues related to credit risk management.

The outcome of this exercise will be the issuance of a consultative paper *Principles for the Management of Credit Risk*. This guidance is organised around seventeen principles related to: (1) establishing an appropriate credit risk environment; (2) operating under a sound credit granting process; (3) maintaining an appropriate credit administration, measurement and monitoring process; (4) ensuring adequate controls over credit risk; and (5) the role of supervisors. The paper emphasises that banks must manage the credit risk in all their activities, both in the banking book and in the trading book, and on and off the balance sheet.

Work is also under way on the specific issues of collateral management, asset securitisation and credit derivatives.

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

In October 1998, the Basle Committee issued for comment a consultative paper containing sound practice guidance on the valuation of loans, the establishment of loan loss allowances, credit risk disclosure and related matters. The Committee's work in this area is based on the recognition that loan accounting practices are an essential part of sound management and control of credit risk in banks. Accounting practices can significantly affect the accuracy of public financial reporting and the potential for effective market discipline. Loan accounting methods also have a bearing on the effectiveness of supervisory practices, including capital adequacy requirements.

The paper provides guidance on sound practices with respect to the initial recognition and measurement of loans, the measurement of impaired loans, the establishment of loan loss allowances, the recognition of income and the restructuring of troubled debt, as well as sound disclosure practices for loan portfolios, troubled loans, loan loss allowances and related risk management practices.

The comment period has recently ended and once the comments are reviewed and incorporated, the document will be re-issued in final form.

5. Ongoing review of IASC standards

The Basle Committee's Accounting Task Force, comprised of accounting experts from its member institutions, closely follows the work of the International Accounting Standards Committee (IASC) on issues of interest to banking supervisors, in particular the IASC's work on accounting for financial assets and liabilities. The Basle Committee has observer status in several IASC working groups and has also sent observers to meetings of the IASC Board when issues pertinent to the work of the Committee have been discussed.

The Basle Committee has provided a series of comprehensive comment letters on IASC proposals in order to make them aware of the banking supervisory perspective. In these letters, the Basle Committee has expressed its support for efforts to develop and improve international accounting standards that would facilitate a more accurate assessment of the financial condition and performance of banks. However, the Committee has expressed concerns about IASC proposals on broad application of fair value accounting, in particular with respect to banking book loans. It has also noted that it is desirable that hedge accounting standards do not contradict sound risk management practices.

The G-7 Finance Ministers and Central Bank Governors have asked the Basle Committee, IOSCO, and the IAIS to undertake a review of International Accounting Standards (IAS) issued by the IASC. The complexity and large volume of IAS makes such a review challenging and potentially very time-consuming. While the Basle Committee has an interest in harmonised and improved bank accounting standards, it is clear that the Committee is not the appropriate forum to make a comprehensive assessment of the full range of IAS. However, in order to respond to the request, the Committee has developed a work programme to determine the acceptability of IAS from the point of view of banking supervisors' objectives of prudent bank supervision and regulation and enhanced comparability and transparency. Based on its review, the Committee will provide a report to the G-7 Finance Ministers and Central Bank Governors, and the IASC in the second half of 1999. The report will detail the results of the review and make recommendations on how to resolve any inconsistencies or incompatibilities between IASC standards and prudential requirements or principles.

6. Development of guidance to supervisors on evaluating corporate governance at individual banks

The Basle Committee is committed to strengthening the corporate governance of banks. The Committee is drafting a paper that clarifies the role and responsibilities of banks' 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. This effort should complement work being done by the OECD.

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

As a follow-up to its September 1997 paper *The Year 2000: A Challenge for Financial Institutions and Bank Supervisors*, the Basle Committee developed supervisory guidance on the independent assessment of Year 2000 preparations at individual banks. The Joint Year 2000 Council (comprised of senior members of the Basle Committee, IOSCO, the IAIS and the Committee on Payment and Settlement Systems) decided that this guidance should be adopted as a cross-financial industry supervisory guidance (i.e., published by the Joint Council for the benefit of supervisors/overseers of banks, securities firms, insurance companies and payments systems as well as their external auditors). Accordingly, the Basle Committee document, in a slightly revised format, was issued by the Joint Council in July 1998.

During 1998 the Basle Committee also issued a document dealing with Year 2000 cross-border issues and containing a contact list of banking supervisors worldwide (more than 110 countries) responsible for Year 2000 issues. This contact list is periodically updated by the Committee. The Committee also conducted a second survey to gather information on what steps banks and bank supervisors are taking to address the Year 2000 issue. The results of this survey were made available to supervisors and a synopsis of the results, together with a short cover paper, has been posted on the BIS Website.

In early 1999, the Basle Committee issued a guidance paper for bank supervisors on contingency planning. The paper addresses a variety of topics including dealing with different risks, public communications strategies and resource implications. The paper was subsequently released by the Joint Year 2000 Council as part of a larger package of papers on Year 2000 contingency planning by financial sector supervisors. The Committee intends to do further work on contingency planning and issue additional guidance as the millennium approaches. Much of this guidance will be based on lessons learned from past events, including the recent conversion to the Euro. Business continuity and disaster recovery issues will be an important focus of attention in the coming year.

8. Continuation of work on operational risk management and notification to the banking community that a dialogue with supervisors would be helpful

There is currently intense interest in the financial community regarding new approaches to measuring, monitoring and controlling operational risks. Managing operational risk is becoming an important feature of sound risk management practice in modern financial markets. The Basle Committee is continuing its work in this area and in September 1998 made public the results of interviews it conducted with major banks in the various member countries on their management of operational risk. The purpose of these interviews was to assess the current state of the art of operational risk management.

The survey results indicated that, while senior management's awareness of operational risk has been increasing, most banks are only in the early stages of developing a framework for measuring and monitoring operational risk. The Basle Committee intends to continue monitoring developments in this area of risk management and has encouraged banks to share with their supervisors the development of new techniques to identify, measure, monitor and control operational risk.

V. International regulatory cooperation

Since its foundation, the Basle Committee on Banking Supervision has provided a basis for international cooperation in banking supervision. The work of the Committee, whose members are full-time supervisors, 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.

1. Obtaining input on ongoing Basle Committee projects from supervisors in non-G-10 countries through work with the Core Principles Liaison and Consultation Groups

As set out in Section I.1. 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, has submitted a separate, more detailed report prepared by the Joint Forum.

The Basle Committee, along with IOSCO and the IAIS, recently released 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 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 Joint Forum is now 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 Group, 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

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 discuss supervisory issues of mutual concern and to strengthen relationships among supervisors from different countries.

The tenth ICBS was hosted by the Reserve Bank of Australia in Sydney in October 1998. More than 250 supervisors, representing more than 120 countries, participated. The first day of the conference concentrated on the Core Principles, which were endorsed by the conference participants. It was also agreed that monitoring of implementation should be carried out through the Core Principles Liaison Group. The second day focused on banks' management of operational risk, including such topics as business continuity planning, outsourcing, Year 2000 and operational risk in financial market trading.

4. Continuing work on issues related to cross-border banking

Since its foundation in 1975, the Basle Committee has regarded as one of its core responsibilities the need to oversee and, where possible, strengthen the arrangements for the supervision of cross-border banking activities. This has meant defining the supervisory responsibilities of both the home and host supervisors of cross-border groups and seeking to ensure that they are able to carry out those responsibilities without undue impediment.

From the outset, there have been two principal impediments: (1) bank secrecy laws which have prevented home and host supervisors from exchanging prudential information freely, and (2) the ability of home supervisors to conduct effective consolidated supervision of the global activities of the banks headquartered in their jurisdiction. A third problem has been the existence of parallel banks, "shell" branches and similar organisational structures which have blurred the identity of the home and host supervisor.

Several papers have been issued on these topics since the initial supervisory "Concordat" of 1975. In 1996, a joint working group comprised of several members of the Basle Committee and the Offshore Supervisors Group produced a report that set out twenty-nine recommendations designed to remove or circumvent impediments to information exchanges between bank supervisors¹, to provide a framework for the conduct of cross-border inspections, and to strengthen effective consolidated supervision.

¹ These recommendations have obvious synergies with the G-7's Ten Key Principles for Information Sharing.

As a follow-up to this report, a survey was conducted prior to the October 1998 ICBS. Since the principal defence against problems in cross-border banking is the ability of the home country supervisor to obtain early warning of impending difficulties in foreign entities, the survey focussed on two principal issues: access by home country supervisors to information concerning the activities of such entities, and the ability to conduct cross-border inspections. The results of the survey reveal that there has been some improvement in the situation since 1996, especially as far as cross-border inspections are concerned, but since legislation is often required, this is a slow process.

The Basle Committee has recently decided to reconvene the joint working group that produced the 1996 report to study the findings of the latest survey and to decide whether further initiatives are now justified.

5. Review of the Ten Key Principles for Information Sharing

The Basle Committee welcomes the Ten Key Principles for Information Sharing described in the report of the G-7 Finance Ministers entitled *Financial Stability – Supervision of Global Financial Institutions*.

These principles further the work of the Basle Committee, which in July 1992 adopted the *Minimum Standards for the Supervision of International Banking Groups and their Cross-border Establishments*. One of the minimum standards is that “supervisory authorities should possess the right to gather information from the cross-border banking establishments of the banks or banking groups for which they are the home country supervisor.” In 1996, the Basle Committee elaborated upon the necessity of improving the access of home supervisors to information necessary for effective consolidated supervision in its paper *The Supervision of Cross-border Banking*. In its 1997 paper *Core Principles for Effective Banking Supervision*, the Basle Committee recognised that information exchange among supervisors is a key component of consolidated supervision of multinational banking organisations. More recently, the Committee conducted surveys of supervisors worldwide on their adherence to the recommendations in both of the cross-border banking papers as well as the Core Principles, including those regarding access of home country supervisors to information.

In addition, the Ten Key Principles are specifically noted in an annex to the *Principles for Supervisory Information Sharing* paper that the Basle Committee proposed through the Joint Forum on Financial Conglomerates. As noted in their separate report, the members of the Joint Forum performed a self-assessment of their compliance with the Ten Key Principles.

6. Continuing commitment to increasing cooperation with non G-10 regional supervisory groups through participation in their meetings and 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.

7. 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 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, which is updated twice a year, is distributed not only to banking supervisors but also to IOSCO and the IAIS.

30 March 1999