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

Basel Committee on Banking Supervision (BCBS)

In July, members of the BCBS reached agreement on a number of important issues concerning the New Basel Capital Accord that the Committee had been exploring since the release of its second consultative paper in January 2001.\(^1\) The Committee considered a range of issues related to both the standardised and internal ratings-based (IRB) approaches to credit risk, and agreed to make a number of amendments to the proposals contained in its second consultative document. It also confirmed its intent to finalise the New Basel Capital Accord in the fourth quarter of 2003, allowing for implementation of the new framework in each country at year-end 2006.

In the same month, the BCBS also announced that it would be conducting a third and final Quantitative Impact Study (QIS 3).\(^2\) The new study will be a comprehensive exercise, allowing the Committee to assess the impact of various proposals before a third consultative paper on the New Basel Accord is published in 2003. The survey will involve banks in G10 and non-G10 countries and include both large, internationally active, diversified institutions and smaller banks. It will encompass results on all three new approaches proposed by the BCBS (standardised, foundation IRB and advanced IRB) and will analyse the effects of the new proposals on all portfolios. The survey forms were released in early October, including an information package with detailed instructions and spreadsheets with embedded risk weights. Financial institutions have been asked to return their submissions by year-end 2002. The Committee will assess the results of the survey to determine whether any adjustments need to be made prior to the release of an updated revision of its proposals for public comment in the second quarter of 2003.

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\(^1\) See [Basel Committee reaches agreement on New Capital Accord issues](http://www.bis.org), BCBS, Basel, July 2002, at www.bis.org.

\(^2\) See [Results of Quantitative Impact Study 2.5](http://www.bis.org), BCBS, Basel, July 2002, at www.bis.org.
Also in July, the BCBS published a new draft of a consultative paper originally published in December 2001 on the development of sound practices for the management and supervision of operational risk.\(^3\) The paper outlines a set of principles that provide a framework for the effective management and supervision of operational risk, for use by banks and supervisory authorities when evaluating operational risk management policies and practices. The Committee recognises that the exact approach for operational risk management at individual banks will depend on a range of factors, including their size, sophistication and the nature of their activities. However, despite these differences, clear strategies and oversight by the board of directors and senior management, a strong internal control culture, appropriate internal reporting, and contingency planning are all crucial elements of an effective operational risk management framework for all banks. Given the number of important changes, the Committee decided to release the paper for a second, short period of consultation before finalising it.

In August, the BCBS published the results of a survey of internal audit issues in banks in 13 countries, which utilised the framework contained in the Committee’s best practice paper issued in August 2001.\(^4\) The information about banks was gathered from national supervisory authorities and supplemented by interviews with internal auditors and other related parties. The survey found widespread endorsement of the key internal audit principles identified by the BCBS as reflecting best practice within the banking industry. In particular, there was broad recognition of the importance of independent and competently staffed internal audit functions. Responses further indicated that boards of directors and audit committees were devoting time and effort to ensuring that their banks maintained appropriate internal controls and risk management protocols and complied with laws and regulations. Almost all banks surveyed already have an audit charter in place or are currently drafting one.

In September, regulators representing nearly 120 countries attended the International Conference of Banking Supervisors (ICBS) in Cape Town.\(^5\) They announced their commitment to fight the funding of terrorist activities and the laundering of funds related to these activities by strengthening the enforcement of measures that make it harder to disguise the ownership of bank accounts. Regulators also pledged to support the standards set out in the BCBS’s report on customer due diligence for banks, and endorsed the adoption of know-your-customer procedures within individual jurisdictions and the sharing of

\(^3\) See Sound practices for the management and supervision of operational risk, BCBS, Basel, July 2002, at www.bis.org.


\(^5\) The ICBS is a biennial event, held since 1979, which is attended by senior representatives of supervisory authorities worldwide. Its aim is to promote cooperation among national authorities in the supervision of international banking and to facilitate exchanges of views on a range of issues of common concern.
information related to terrorist financing and money laundering with other supervisors and law enforcement agencies.\(^6\)

Committee on Payment and Settlement Systems (CPSS)

In September, the CPSS issued a consultative report on central bank policy issues in the area of retail payments.\(^7\) The report, which invites public comments by 13 December 2002, identifies current trends in the markets for consumer and lower-value commercial payments and explores related policy issues for central banks. It describes the varied ways in which central banks are involved in retail payments, and discusses differences in their policy mandates and their respective interaction with the private sector. The report puts forward public policy goals for maintaining and promoting efficiency and safety in these markets and considers the contribution of central banks towards furthering these goals. It identifies a range of possible actions, some of which are recommended as minimum steps for all central banks. Beyond the minimum, other options are identified which may be appropriate in certain circumstances. The recommended minimum actions emphasise the importance of market monitoring and of a cooperative and advisory approach by central banks towards both the private and public sectors.

Financial Stability Forum (FSF)

At its meeting in Toronto in September, the FSF addressed potential vulnerabilities in the global financial system. Although it accepted that the baseline scenario of moderate growth in major industrial countries was still the most likely outcome, it also expressed concerns about the materialisation of downside risks and/or intensification of risk aversion. It was felt that uncertainty was the predominant feature of the current juncture.

The Forum concluded that financial institutions had continued to show remarkable resilience, attesting to the benefits of considerable investment in risk management. However, further equity price declines and credit deterioration had meant that cushions of comfort were thinning, making the system more susceptible should new shocks occur. Material losses had been sustained by non-bank entities supporting the credit intermediation process, the full effect of which on credit supply was unclear. Equity price declines had made it harder for insurance companies to deal with negative margin problems.

The FSF also reviewed work under way to address weaknesses in market foundations revealed by recent corporate failures, including national and international initiatives to strengthen corporate governance, auditing quality, accounting standards and public disclosure practices. The Forum emphasised the importance of seizing the current opportunity to pursue implementation of


needed reforms and to bring about greater international coherence, based on high-level principles. The FSF will continue to promote coordination and coherence across countries and sectors and monitor developments closely. It will also study the role of credit rating agencies, based on a large-scale review now being conducted by the US Securities and Exchange Commission.

The FSF also examined the state of the reinsurance industry. Although there were no suspicions that major reinsurance companies faced serious difficulties, it was agreed that more information on the global reinsurance market, individual reinsurers and the rating process was needed to assess systemic concerns and risk management capacity at individual institutions. The FSF asked the key regulators in the jurisdictions in which the major reinsurers were located to take a leading role in the International Association of Insurance Supervisors’ (IAIS) initiative to improve transparency in the global reinsurance market and enhance risk disclosure by individual reinsurance companies. The Forum also supported the work of the IAIS to develop an improved and comprehensive framework for the regulation of the global reinsurance industry and the effort by the International Accounting Standards Board to develop principles for insurance and reinsurance accounting.

With regard to previous concerns, the FSF supported periodic reviews by the IMF and the BIS of the highly leveraged institution (HLI) industry, based on data that is commercially, and anecdotally, available, which could provide early warning of increases in leverage. The FSF also reviewed the progress made in the IMF’s assessments of offshore financial centres (OFCs). OFCs are expected to complete assessments of their observance of international standards, along with action plans to address any shortcomings, by 2003.