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

Basel Committee on Banking Supervision

The BCBS releases recommendations concerning shell banks ...

In January, the Basel Committee on Banking Supervision (BCBS) released an analysis of banks' management of global operations.[1] The paper identifies a number of structures posing problems for effective banking supervision. In particular, it notes that, to be in line with the Core Principles for Effective Banking Supervision, supervisory authorities should no longer approve the establishment of shell banks or accept their continued operation.[2] Where shell banks already exist, supervisors should set a short deadline for banks to establish a meaningful presence and management in their jurisdiction, after which time their licences should be withdrawn if they have not complied. The relocation of presence and management should be genuine and not cosmetic, and should permit the supervisor to apply the full range of supervisory tools in accordance with the Core Principles.

... issues principles for the management of operational risk ...

In February, the BCBS released a paper outlining principles for the effective management and supervision of banks' operational risk.[3] The BCBS recognises that an individual bank's particular approach to operational risk management will depend on a range of factors, including its size and sophistication and the nature and complexity of its activities. However, despite these differences, clear strategies and oversight by the board of directors and senior management, a strong operational risk culture and internal control culture, effective internal reporting and contingency planning are all crucial elements of an effective operational risk management framework for banks of any size and scope.

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1 See *Shell banks and booking offices*, BCBS, January 2003, at www.bis.org.

2 See *Core Principles for Effective Banking Supervision*, BCBS, April 1997, at www.bis.org.

3 See *Sound practices for the management and supervision of operational risk*, BCBS, February 2003. The paper was published for a second period of consultation in July 2002 and this is the final version.

In March, the BCBS released a paper summarising the results of data collected in June as part of the 2002 Operational Risk Loss Data Collection Exercise (LDCE).[4] The 2002 LDCE asked participating banks to provide information on individual operational losses during 2001, internal capital allocation for operational risk, expected operational losses and a number of exposure indicators tied to specific business lines. The paper describes the results of the 2002 LDCE and compares the data with those compiled in previous data collection efforts. Focusing on the individual loss event data submitted by participating banks, it analyses the range of individual gross loss amounts and the distribution of these losses across a set of standardised business lines and event types. It also evaluates the information banks reported on insurance and other recoveries associated with these individual loss events. Finally, the paper briefly examines the data collected on the share of economic capital that the participating banks allocated to operational risk, as well as their use of information on expected operational losses for pricing, reserving and expensing.

... and analyses the results of a survey on operational risk losses

Committee on Payment and Settlement Systems

In March, the Committee on Payment and Settlement Systems (CPSS) published a report on policy issues for central banks in retail payments.[5] The report identifies current trends in the markets for consumer and lower-value commercial payments and explores related policy issues for central banks. It puts forward four public policy goals for maintaining and promoting efficiency and safety in these markets. These relate to: (i) the legal and regulatory framework; (ii) market structure and performance; (iii) standards and infrastructure; and (iv) central bank services. Furthermore, it considers the contribution central banks can make to attaining these goals and identifies a range of possible actions. 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. Central bankers share the view that market mechanisms should be the primary engine for achieving and maintaining efficiency and safety in retail payments. However, they acknowledge that the market may encounter persistent impediments that prevent appropriately efficient and safe outcomes in all cases.

The CPSS publishes a report on policy issues in retail payments

Committee on the Global Financial System

In January, the Committee on the Global Financial System (CGFS) released a report on credit risk transfer (CRT) mechanisms, such as financial guarantees and credit insurance.[6] The report reviews the recent development of CRT

The CGFS releases a report on credit risk transfers ...

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4 See *The 2002 loss data collection exercise for operational risk: summary of the data collected*, BCBS, March 2003, at www.bis.org.

5 See *Policy issues for central banks in retail payments*, CPSS, March 2003, at www.bis.org. An earlier version was issued in September last year as a consultation document.

6 See *Credit risk transfer*, CGFS, January 2003, at www.bis.org.

markets, describing the characteristics of the instruments used, the nature of the market participants and the reasons for their involvement. It also discusses some of the principal features of the markets themselves, focusing on questions of transparency and data availability, on how CRT instruments of different kinds are priced and on how far the existence of CRT markets has affected the process of price discovery. The report concludes by identifying possible implications of the evolution of CRT markets for the overall functioning of the financial system and discusses some of the concerns which have been expressed about the impact of CRT on financial stability. Such concerns relate inter alia to transparency in the disclosure of CRT activities, market concentration, the robustness of documentation, the adequacy of risk management and the potential for regulatory arbitrage.

… and another on the institutional asset management industry

In March, the CGFS published a report on trends in the institutional asset management industry.[7] The CGFS gathered information about the evolving structure of the asset management industry and possible implications of industry trends for financial markets. The information gathering effort included two rounds of interviews with more than 100 industry practitioners from 14 countries. Since asset management involves a delegation of responsibilities, appropriate incentive structures are essential for aligning the incentives of owners of funds with those of the institutional managers of these funds. In an industry that is growing strongly, structural changes are likely to affect market outcomes. The report makes a number of specific recommendations regarding risk management and disclosure, conflicts of interest, explicit and implicit barriers to market entry and regulatory trade-offs.

Financial Stability Forum

The FSF discusses vulnerabilities in financial systems …

In March, the Financial Stability Forum (FSF) met in Berlin to discuss two broad topics: a review of potential vulnerabilities in the international financial system and progress made in addressing weaknesses in market foundations.

Members reviewed various underlying sources of economic and financial strength and weakness. An important element has been developments in corporate and household sector balance sheets and the sensitivity of those balance sheets to changes in interest rates and exchange rates. Members reviewed a number of financial factors that could be important to the economic outlook, including volatility in equity markets, various strains affecting some parts of the banking and insurance sectors, and credit risk transfer activity. Members considered the ongoing adjustment in emerging market economies and their improving access to international capital markets. They observed that most emerging market economies were pursuing generally sound macroeconomic policies and had been able to arrange financing quite well, as needed. Nevertheless, some concerns were identified that could arise if the global economy were to remain weak or if sound policies were not sustained.

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7 See *Incentive structures in institutional asset management and their implications for financial markets*, CGFS, March 2003, at www.bis.org.

The FSF reviewed the actions taken at national and international level to address weaknesses in market foundations. Encouraging progress has been achieved to date. On the whole, national reform initiatives are aimed at similar objectives across countries, and cross-border consultations have been extensive, laying the basis for stronger and internationally more coherent market foundations. But work remains to be done to implement and enforce the reforms taking shape. To sustain the momentum, actions in a number of areas were thought to be desirable, including corporate governance, auditor independence and oversight, audit practice standards and accounting standards.

... reviews progress in addressing weaknesses in market foundations ...

The FSF emphasised again the importance of progress by offshore financial centres (OFCs) in bringing their supervisory, regulatory, information sharing and cooperation practices up to international standards. The FSF welcomed the significant advances achieved in the IMF's assessment programme and reiterated its expectation that IMF-led assessments of all significant jurisdictions listed in the FSF groupings of May 2000 will be completed by the end of 2003. The FSF recognises that resource limitations can be a constraint in the implementation of standards and calls upon its members to strengthen the provision of technical assistance to promote further progress by OFCs. The FSF will assess the overall effectiveness of its OFC initiative in September 2003.

... and emphasises that OFCs should adopt international standards

Other initiatives

In February, central banks contributing to the BIS international consolidated banking statistics announced that they had agreed to collect more complete and detailed statistics on banks' country risk exposures from the end of 2004. The BIS sees these changes as helping enhance the status of its consolidated banking statistics as a key data source for monitoring and analysing international financial market developments. The improved statistics on banks' financial claims vis-à-vis foreign borrowers will feature the following additional information on an ultimate risk basis:[8] separate country breakdowns of banks' on-balance sheet cross-border claims and local claims of their foreign offices; a sectoral breakdown of total on-balance sheet claims; data on derivatives exposures by country; and separate country breakdowns of guarantees and credit commitments. The new agreement among contributing central banks has its origin in a September 2000 report of a working group set up by the CGFS on the BIS international banking statistics.[9]

The BIS announces it will collect more complete banking statistics

In March, the G10 central bank governors and heads of banking supervision met in Basel to discuss the work of the BCBS. The participants in the meeting confirmed the ongoing importance of the BCBS's work, in particular the establishment of global benchmarks for capital adequacy

The G10 banking authorities confirm plans for updating the Capital Accord

[8] That is, claims secured by a guarantee or collateral are allocated to the country of the guarantee/collateral issuer, not that of the immediate contractual counterparty.

[9] See *Report of the Working Group on the BIS International Banking Statistics*, CGFS, September 2000, at www.bis.org.

regulation. These efforts provide a critical foundation for international cooperation regarding the stability of the global banking system. The participants reaffirmed their strong support for updating the existing Capital Accord and welcomed the progress that the BCBS had made on this important project. Based on a discussion of the BCBS's work, the participants supported plans to release a third consultative package for public comment by early May, believing that this additional opportunity for comment will form the basis for a successful conclusion to the BCBS's efforts to develop, on the timetable previously announced, a Capital Accord that is more closely aligned with risks in the banking system.

The G10 Ministers and Governors release a report on CACs

In the same month, the G10 Ministers and Governors approved the public release of a report on collective action clauses. An important factor complicating the rapid and orderly resolution of sovereign debt crises is the collective action problem, whereby the incentives of individual creditors diverge from those of creditors as a whole. This problem has become more acute as bond finance has accounted for an increasing share of sovereign borrowing, leading to growing interest in mechanisms to facilitate faster and more orderly debt restructuring. In that context, the report sets out the key features of collective action clauses for sovereign bonds that the G10 Ministers and Governors believe would, if widely adopted, make the resolution of debt crises more orderly. It also contains an annex with examples of clauses that conform to the key features identified by the working group.