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

Basel Committee on Banking Supervision

The BCBS issues three notes

In January, to clarify various aspects of the new capital adequacy framework, the Basel Committee on Banking Supervision (BCBS) published three technical papers. One deals with the treatment of unexpected losses, one with securitisation and one with cross-border operational risk.

The first discusses a move to risk weights based on unexpected loss

The first note, *Modifications to the capital treatment for expected and unexpected credit losses*, is a response to comments on a new proposal by the BCBS on risk weights for capital purposes. In October 2003, the BCBS had announced its intention to move to a risk weighting based only on *unexpected* loss, while allowing provisions to deal with *expected* loss. The Committee had asked for comments on this revision, and received 52 comment letters. Respondents generally welcomed the solution and agreed that it would align regulatory capital more closely with the concepts underpinning banks' economic capital modelling processes. Many respondents, however, requested the BCBS to provide more detailed information on the new framework. With this in mind, the note describes the concrete modifications decided upon at a meeting in January 2004. In summary, for the internal ratings-based (IRB) approach, expected losses will be removed from the risk weight functions. However, banks will be required to compare their actual provisions with expected losses. Any shortfall should be deducted equally from Tier 1 and Tier 2 capital and any excess will be eligible for inclusion in Tier 2 capital subject to a cap. The current treatment of general provisions will be withdrawn from the IRB approach. The BCBS does not intend to make any changes to the standardised risk weights. Where banks are partly on the standardised approach and partly on the IRB approach, an element of general provisions may be retained in Tier 2 capital.

The second deals with changes to the securitisation framework ...

The second note, *Changes to the securitisation framework*, deals with plans to revise the IRB approach to securitisation exposures. In response to public comments on the *Third consultative paper (CP3)* on Basel II, the BCBS had announced in October 2003 that it would modify its approach to these exposures. At its January 2004 meeting, it specified changes that address industry concerns over the complexity of the securitisation proposal and the operational burden related to its implementation. In addition, the BCBS focused on industry comments regarding the need for greater internal consistency among the proposals comprising the securitisation framework. The technical note provides an overview of the Committee's current thinking on how the securitisation framework for banks that adopt the IRB approach to credit risk will be restructured. The BCBS is simplifying the framework and promoting greater consistency among the available approaches in the following manner. First, it is planning to adopt a procedure for certain low-risk unrated positions that more closely reflects leading banks' current risk management practices. Second, it will offer simpler alternatives to the supervisory formula presented in CP3 for the treatment of unrated positions, which some respondents considered to be unnecessarily complex and computationally burdensome. Third, it is considering ways to add flexibility to the top-down approach to calculating capital charges on purchased receivables so as to facilitate the calculation of the capital charge that would have been applied to the underlying exposures had they not been securitised. Fourth, all externally rated positions will be treated under the ratings-based approach (RBA), regardless of whether the bank is an originator or an investor and whether the position falls above or below the capital charge threshold. Finally, the lowest set of risk weights under the RBA will be applied to "senior" positions rather than to those that are "thick" positions as defined in CP3. Some changes to the risk weights are also proposed.

... with a view to simplifying it and making it more consistent

The third note, *Principles for home-host recognition of AMA operational risk capital*, sets out an approach to operational risk capital allocation that addresses concerns expressed by a number of organisations in their *Comments on CP3* about practical impediments to the cross-border implementation of an advanced measurement approach (AMA) for operational risk. This approach shows how a banking organisation calculating a group-wide AMA capital requirement might calculate the operational risk capital requirements of its subsidiaries.

The third examines cross-border operational risk

Committee on Payment and Settlement Systems

In March, the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commissions (IOSCO) released a consultative report entitled *Recommendations for Central Counterparties*. The report, prepared by a joint Task Force on Securities Settlement Systems (SSSs), sets out comprehensive standards for risk management of a central counterparty (CCP).[1] A well designed CCP with appropriate risk management arrangements reduces the risks faced by SSS participants and contributes to the goal of financial stability. CCPs have long been used by derivatives exchanges and a few securities exchanges. In recent years, they have been introduced into many more securities markets, including cash and over-the-counter markets. Although a

The CPSS publishes recommendations for central counterparties

[1] A central counterparty interposes itself between counterparties in financial transactions, becoming the buyer to the seller and the seller to the buyer.

CCP has the potential to reduce risks to market participants significantly, it also concentrates risks and responsibilities for risk management. Therefore, the effectiveness of a CCP's risk control and the adequacy of its financial resources are critical aspects of the infrastructure of the markets it serves. In the light of the growing interest in developing CCPs and expanding the scope of their services, the CPSS and the Technical Committee of IOSCO concluded that international standards for CCP risk management are a critical element in promoting the safety of financial markets.

Financial Stability Forum

The Financial Stability Forum (FSF) met in Rome on 29–30 March. Discussion focused on three key topics: vulnerabilities in the international financial system; offshore financial centres; and market foundations and corporate governance.

Vulnerabilities in the international financial system

FSF members become more optimistic about the global upswing

FSF members were more optimistic about the global upswing than at their previous meeting in September 2003. Recovery was being supported by accommodative policies, favourable financing conditions and rising corporate profits. Balance sheets of financial corporations had generally improved, increasing systemic resilience. However, members felt that there could be risks relating to interest rates, inflation, asset valuations and market liquidity as the global economy strengthened and policies eventually moved to more neutral settings. In addition, substantial international imbalances persisted and it was thought that these could present challenges going forward.

Members focus on household indebtedness and the external financing of EMEs

Members reviewed the risks and policy implications of high levels of household indebtedness in many countries. Most felt that this indebtedness was unlikely to pose a significant direct risk to financial system stability but could increase the sensitivity of consumer spending to interest rate or income shocks. In emerging market economies (EMEs), fundamentals and external financing conditions had improved further, reflected in a marked compression of spreads on EME debt. Some members expressed concern that conditions might tighten in the period ahead, perhaps in response to a shift in policies in major economies or a sudden shock affecting investor confidence.

Turning to other areas, the Forum received a report from the International Association of Insurance Supervisors (IAIS) Task Force on Enhancing Transparency and Disclosure in the Reinsurance Sector. The Task Force had developed a framework for collecting, processing and publishing reinsurance market statistics covering a significant proportion of global activity. The statistics will be published later this year and will enhance transparency in the sector. However, more needs to be done to improve disclosure. In that regard, members welcomed the establishment of the IAIS Steering Group on Transparency in the Reinsurance Sector to carry work forward.

They also discuss a Joint Forum study on credit risk transfer

Members also exchanged views on interim results of a Joint Forum study on credit risk transfer. The study covers recent market developments, market participants' understanding of the risks involved, possible credit risk concentrations and risk management practices. Members saw great value in this work and looked forward to ongoing efforts in this area.

Offshore financial centres (OFCs)

The Forum discussed progress made by OFCs in strengthening regulatory and information exchange standards. Members judged that progress had been made but that further reform was required in a number of OFCs. The Forum encouraged these OFCs to maintain reform momentum, making use of technical assistance from the IMF and others. It placed particular emphasis on improvements to cross-border cooperation and information exchange. In this respect, members strongly urged all OFCs to publish their IMF assessments.

Market foundations and corporate governance

Members exchange views on corporate governance ...

Members noted that recent corporate incidents, including the Parmalat case, had highlighted the importance of implementing measures to strengthen corporate governance and financial reporting frameworks. But they also illuminated other issues, inter alia the need to review implementation of existing standards on information exchange and cooperation, the role of unregulated entities and complex group structures, the adequacy of risk management in large commercial and investment banks and corresponding regulatory challenges. The FSF welcomed the creation by IOSCO's Technical Committee of a special Chairmen's Task Force to look into several of these issues.

... and greet reforms carried out by IFAC ...

The Forum greeted the adoption by the International Federation of Accountants (IFAC) of reforms on audit-related standard-setting activities, including the proposal to create an independent Public Interest Oversight Board (PIOB) to monitor and review progress in this area. Forum members urged that this important body be set up as soon as possible. Members also looked forward to the results of a survey on national auditor oversight arrangements that is to be led by IOSCO.

... as well as work by the IASB and the FASB

With regard to accounting, members welcomed the completion by the International Accounting Standards Board (IASB) of improvements to existing standards, progress in the convergence project with the Financial Accounting Standards Board (FASB), and the efforts of all parties to finalise IAS 39. The FSF noted the need for further work on outstanding issues, taking into account financial stability considerations.

Finally, members reviewed matters relating to credit rating agencies (CRAs) in the light of the US Securities and Exchange Commission's follow-up to its *Concept Release* on CRAs, which was issued in June 2003. Members also welcomed the establishment by IOSCO's Technical Committee of a task force to develop a code of conduct for CRAs.