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

Basel Committee on Banking Supervision

Financial firms seem to have made good progress in improving their disclosure practices but greater levels of disclosure would still be desirable.[1] This was the conclusion of a report released in May by the Joint Forum.[2] Entitled *Financial Disclosure in the Banking, Insurance and Securities Sectors: Issues and Analysis*, the report examines the progress made by financial firms in adopting the recommendations made by the Multidisciplinary Working Group on Enhanced Disclosure (also called the Fisher II working group) in April 2001, and other efforts of regulators and standard setters in the area of financial disclosure.

New capital adequacy framework released

In June, central bank governors and the heads of bank supervisory authorities of the G10 met and endorsed the publication of *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, the new capital adequacy framework commonly known as Basel II (see the special feature on page 41).

The Basel II framework, which was developed by the Basel Committee on Banking Supervision (BCBS), sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations. The new framework reinforces these requirements by laying out principles for banks to assess the adequacy of their capital and for supervisors to review such assessments to ensure banks have adequate capital to support their risks. It also seeks to strengthen market discipline by enhancing transparency in banks' financial reporting. The text reflects the results of extensive consultations with supervisors and bankers worldwide. It will serve as the basis for national rule-making and approval processes to continue and for banking organisations to complete their preparations for the new framework's implementation.

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[1] The report is available on the websites of the BIS (www.bis.org), the International Organization of Securities Commissions (IOSCO; www.iosco.org) and the International Association of Insurance Supervisors (IAIS; www.iaisweb.org).

[2] The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), IOSCO and the IAIS to deal with issues common to the banking, securities and insurance sectors.

Basel II embraces a comprehensive approach to risk management and bank supervision. It should enhance banks' safety and soundness, strengthen the stability of the financial system as a whole, and improve the financial sector's ability to serve as a source of sustainable growth for the broader economy.

Basel II emphasises risk measurement and management

The Basel Committee intends the new framework to be available for implementation in member jurisdictions as of year-end 2006. The most advanced approaches to risk measurement will become available as of year-end 2007, in order to allow banks and supervisors to benefit from an additional year of impact analysis or parallel capital calculations under the existing and new rules.

The G10 governors and supervisors supported the Committee's plans to continue discussions on key implementation issues with the industry and other authorities as domestic adoption and approval processes proceed. They also encouraged authorities in non-BCBS jurisdictions to consider the readiness of their supervisory structures for the Basel II framework and recommended that these jurisdictions proceed at their own pace, and according to their own priorities.

In June, the BCBS announced that it had discussed the potential impact of the implementation of international financial reporting standards (IFRS) on regulatory capital and whether it should be adjusted. Under IAS 39, the cumulative fair value gains and losses on cash flow hedges of financial instruments measured at amortised cost are recognised directly in equity but only to the extent the hedges are considered effective. The Committee believes that, for regulatory capital purposes, it would be appropriate for national supervisors to exclude the cumulative gains and losses from the definition of Tier 1 and Tier 2 capital.

Potential impact of IAS 39 on regulatory capital

The BCBS also examined the appropriate regulatory treatment of any gains and losses arising from changes in an institution's own credit risk as a result of applying the fair value option to its liabilities. The Committee believes that the potential inclusion of these gains and losses in Tier 1 or Tier 2 capital raises significant supervisory concerns, and that they should be excluded. Accordingly, it takes the view that it would be appropriate for national supervisors not to recognise these gains and losses in regulatory capital. Application of the fair value option may also have other supervisory implications with respect to regulatory capital. The BCBS will continue to review these implications concurrently with the International Accounting Standards Board's planned finalisation of its revised approach to the fair value option, along with other consequences of the introduction of IFRS.

Financial Stability Forum

In May, the Financial Stability Forum (FSF) held its third regional meeting in the Asia-Pacific region in Beijing, China. Meeting participants exchanged views on strengths and vulnerabilities in international and regional financial systems. They agreed that growth has been particularly strong in the Asia-Pacific region, reflecting domestic structural reform and policy improvements, the global recovery and a benign global financing environment. Another topic was policy challenges faced by regional authorities in managing a sustainable upturn and maintaining financial system soundness. There was particular interest in the adjustment path of the Chinese economy and the possible consequences this could have for the regional and global economy. Participants also discussed the potential impact on regional economies and financial systems of the transition of global interest rates to more neutral settings, high oil and commodity prices, global imbalances and rising household indebtedness.

FSF regional meeting in Asia on strengths and vulnerabilities in financial systems

The meeting reviewed recent progress made in strengthening regional financial systems, and the associated challenges that lie ahead. The participants shared the view that, though strong growth in the region has generally reduced levels of non-performing loans and increased profitability of banks, challenges remain in a number of regional financial sectors. In particular, banks' capacity to manage various risks associated with growing new business areas, such as consumer lending, needs to be strengthened. Participants pointed to the importance of coordination among financial authorities in the development of domestic and regional bond markets as a means of deploying regional savings more effectively, increasing financial resiliency and enhancing the competitive environment in the financial sector as a whole. They also exchanged views on regional experiences with regard to the entry of foreign financial institutions into the domestic markets, including its impact on financial efficiency and stability, and the related supervisory issues. They noted the increased activities of hedge funds in financial markets and the need for adequate risk management, counterparty discipline and transparency.

Participants considered the regional implications of current international initiatives to strengthen corporate governance, transparency and audit quality and to put in place stricter enforcement mechanisms, focusing on the most critical reforms and the obstacles that need to be overcome. They attached particular importance to ensuring robust corporate governance in the financial sector, especially in banks, given their dominant role in regional financial systems. Participants also emphasised the need for enhanced audit quality and auditor oversight mechanisms, as well as efforts to strengthen accounting standards. Note was taken of the work of the International Organization of Securities Commissions with regard to credit rating agencies. Participants underscored that further headway is needed in all these areas, in the region as elsewhere.

Regional participants also exchanged views on the Basel II framework. They noted that a certain level of flexibility for non-G10 countries regarding the implementation schedule would support the smooth transition to the new framework.