

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

Following its release towards the end of June, the new capital adequacy framework (Basel II) remained centre stage in the ensuing months as the focus shifted from endorsement to implementation. More generally, various aspects of vulnerabilities in the international financial system and the associated challenges were the dominant theme of the period under review. Table 1 provides a selective chronological overview of the most recent initiatives.

### Basel Committee on Banking Supervision

BCBS issues revised paper on interest rate risk management and supervision ...

In July, the Basel Committee on Banking Supervision (BCBS) issued a revised version of a 1997 paper on the principles for the management of interest rate risk. Entitled *Principles for the management and supervision of interest rate risk*, the revised paper is designed to be fully consistent with the Pillar 2 approach to interest rate risk in the banking book under the new capital adequacy framework, which sets out the details for adopting more risk-sensitive minimum capital requirements for banking organisations.

... and a document on implementation aspects of Basel II

The Committee also published the discussion document *Implementation of Basel II: practical considerations*, reflecting its long-held view that the release alone of Basel II is not the end of, but rather an important milestone in an ongoing effort to encourage the process of international convergence of capital standards. With the publication of this document, the Committee recognises that, while the new framework was designed to address global issues, moving towards its adoption in the immediate future may not be the main priority for many supervisors in non-G10 countries. Indeed, given national resource and other constraints, there may be more immediate regulatory concerns that need to be dealt with before Basel II compliance in order to strengthen the respective financial systems.<sup>1</sup> Despite this, a large number of the national supervisors not represented in the Committee have already begun to tackle implementation issues and, in order to advance this process, last year the BCBS convened a working group with a mandate to provide practical pointers to supervisors for

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<sup>1</sup> The IMF and World Bank indicated that future financial sector assessments will not be based on Basel II if a country has not elected to implement it, but rather on the performance relative to the chosen standards.

Main initiatives by Basel-based committees and other bodies			
Press releases and publications over the period under review			
Body	Initiative	Thematic focus	Release date
BCBS	Implementation of Basel II: practical considerations	<ul style="list-style-type: none"> <li>• Cost and benefits of national implementation</li> <li>• Pillar-specific implementation</li> <li>• Changes to legal and regulatory framework</li> </ul>	July 2004
	Principles for the management and supervision of interest rate risk	<ul style="list-style-type: none"> <li>• Source of interest rate risk</li> <li>• Sound practices, policies and procedures</li> <li>• Internal controls, disclosure and supervision</li> </ul>	
	Capital treatment of certain items under international financial reporting standards (IFRS)	<ul style="list-style-type: none"> <li>• Impact on regulatory capital</li> </ul>	
	Thirteenth International Conference of Banking Supervisors (ICBS)	<ul style="list-style-type: none"> <li>• Pledge for deeper cooperation</li> </ul>	September 2004
Joint Forum <sup>1</sup>	Outsourcing guidance to the financial sector	<ul style="list-style-type: none"> <li>• Guiding principles, current trends</li> <li>• Regulatory developments, key risk</li> </ul>	August 2004
	Report on credit risk transfer (CRT)	<ul style="list-style-type: none"> <li>• Degree of risk transfer achieved by instruments/transactions</li> <li>• Agents' understanding of risks involved</li> <li>• Concentration risk due to CRT</li> </ul>	October 2004
FSF	Twelfth meeting and progress report	<ul style="list-style-type: none"> <li>• Financial system vulnerabilities</li> <li>• Financial sector regulation</li> <li>• Issues relating to prior concerns</li> </ul>	September 2004
<sup>1</sup> The Joint Forum was established in 1996 under the aegis of the Basel Committee on Banking Supervision (BCBS), the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).			
Source: Relevant bodies' websites (www.bis.org and www.fsforum.org).			Table 1

the transition to the new framework. Not intended to be an interpretation of Basel II, the document summarises the discussion of the working group and offers suggestions that can be adapted in different jurisdictions.

In a similar vein, following an earlier discussion of the potential impact of the implementation of international financial reporting standards (IFRS) on regulatory capital and whether this measure should be adjusted accordingly, the BCBS announced that, for the time being, it does not plan to encourage national supervisors to make adjustments to the existing capital adequacy framework, including the definition of capital.

BCBS advises no adjustment to measurement of capital due to IFRS

At the 13th International Conference of Banking Supervisors (ICBS) in Madrid in late September, banking supervisors from over 120 countries pledged deeper cooperation to fortify the stability of the financial system and to encourage improvements in banks' management of risk. They discussed the implementation of the new international framework for bank capital

Banking supervisors from 120 countries promise closer cooperation

requirements as well as current issues in accounting. Specific emphasis was given to the need to reinforce the infrastructure for banking and supervision by applying the principles behind Basel II. The event aims to promote cooperation among national authorities in the supervision of internationally active banking organisations. It has been held biennially since 1979 and this year was organised jointly by the Bank of Spain and the BCBS.

## Joint Forum

Joint Forum releases two reports, dealing with various aspects of outsourcing ...

In August, the Joint Forum released a report entitled *Outsourcing in financial services*, recognising the global trend of internationally active financial services businesses increasingly relying on third parties to perform activities they would have previously undertaken themselves. The report examines the growth and other stylised facts of outsourcing and outlines the potential associated risks to individual firms in particular and the financial sector in general. It also presents a set of best practice principles for entities engaged in outsourcing activities, providing a minimum benchmark against which to gauge individual outsourcing efforts. The Joint Forum developed these principles in conjunction with the International Organization of Securities Commissions (IOSCO), which is producing a specific set of principles for the securities industry. The Joint Forum and the International Association of Insurance Supervisors (IAIS) will consider whether additional guidance on outsourcing for the banking and insurance sectors is necessary.

... and the impact of credit risk transfer on financial stability

In response to a request by the Financial Stability Forum (FSF), the Joint Forum's Working Group on Risk Assessment and Capital published in October a keenly anticipated report entitled *Credit risk transfer*. The report focuses on three issues highlighted by the FSF in particular: whether instruments/transactions accomplish a clean risk transfer; the degree to which market participants understand the risks involved; and whether CRT activities are leading to undue concentrations of credit risk. It concludes that credit derivatives have achieved a relatively good risk transfer record to date; that market players seem to be largely aware of the risks concerned; and that the concentrations of credit risks pose no immediate threat to financial stability.

## Financial Stability Forum

FSF reviews vulnerabilities in the global financial system ...

In September, the Financial Stability Forum (FSF) held its 12th meeting in Washington DC. The topics addressed fell into six broad categories: potential vulnerabilities in the international financial system; international financial sector standards; credit risk transfer; reinsurance; offshore financial centres (OFCs); and financial reporting.

With regard to *vulnerabilities in the international financial system*, there was broad consensus that the macroeconomic backdrop for financial markets had generally improved since the Forum's March meeting. Several previous downside risks had become less pronounced, and the resilience of key financial systems to shocks had increased further. Nonetheless, the FSF saw little room for complacency and discussed several areas meriting close

monitoring in the period ahead, including: the potential impact of removing policy stimulus; the possible effect of sustained high oil prices on growth and inflation; continuing fiscal and external imbalances in several countries; ongoing uncertainties about the trajectory of the Chinese economy; and the resilience of emerging market economies to these developments. Members also reviewed financial sector vulnerabilities. They noted strengthened levels of capital in the financial system and discussed potential sources of heightened market volatility and impairment of market liquidity. The Forum also discussed the impact of rising inflows to hedge funds on market functioning and on the risk profile of financial institutions, and the progress made to date to strengthen business continuity arrangements in key financial centres.

On the issue of *financial sector standards*, ways of improving implementation in the banking, securities and insurance sectors were considered, based on the experience from the joint IMF/World Bank Financial Sector Assessment Program (FSAP).<sup>2</sup> Members discussed the treatment of preconditions for sound supervision and regulation, the consistency of implementation methodology, cross-sector and cross-border regulation, regulatory and corporate governance, and public disclosure. They concluded that these matters merited further attention from international standard setters, working with the international financial institutions.

... encourages work on financial sector standards ...

On *offshore financial centres* (OFCs), the Forum reviewed work in various international forums, notably the BCBS, the IMF, IOSCO and the Offshore Group of Banking Supervisors, to improve information sharing and cross-border cooperation between on- and offshore authorities on supervisory and regulatory matters. Cooperation and information sharing had generally improved, but problems continued to surround information exchange in connection with investigations involving violations of securities laws. The Forum concluded that further progress was necessary and that tools should be developed, based on objective criteria and due process, to recognise and catalyse improvements, drawing on assessments of OFCs by the IMF and IOSCO.

... discusses initiatives on offshore financial centres ...

Members were also informed of the latest developments in the area of *international accounting standards*, including future plans of the International Accounting Standards Board (IASB) and discussions on convergence between the IASB and the US Financial Accounting Standards Board.<sup>3</sup> As for *audit quality and auditor oversight*, members were concerned about delays to the establishment of the public interest oversight board to oversee IFAC's standard-setting activities and urged its speedy formation.

... and reports on developments on international accounting standards

<sup>2</sup> The FSAP is increasingly emerging as a global standard for national authorities and plays a key role in the new regular reporting framework on financial stability adopted by many central banks. See for instance the Reserve Bank of New Zealand's Financial Stability Report ([www.rbnz.govt.nz/banking/fsr\\_oct2004.pdf](http://www.rbnz.govt.nz/banking/fsr_oct2004.pdf)) for a recent example of how the FSAP is used to benchmark national efforts.

<sup>3</sup> Subsequent to the Forum's main meeting, an October roundtable organised jointly by the FSF, the International Federation of Accountants (IFAC) and the IASB considered issues arising in the implementation of new IFRS in 2005.