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

For the first three quarters of 2004, the endorsement of the new capital adequacy framework (Basel II) and issues related to its implementation were the dominant themes. The last quarter, however, was characterised by more diverse releases by the various Basel-based committees. Table 1 provides a selective overview of the most recent initiatives.

Basel Committee on Banking Supervision

In October, the Basel Committee on Banking Supervision (BCBS) issued a paper on the importance of banks managing their “know-your-customer” (KYC) risks on a global consolidated basis. Entitled Consolidated KYC risk management, the paper is a complement to a 2001 paper, Customer due diligence for banks, and examines the critical elements for the effective group-wide management of KYC risk. The paper emphasises the need for a consistent global approach whereby banks apply the principles of sound KYC risk management both at the head office and at all branches and subsidiaries. Such an approach is based on four essential elements: (i) customer acceptance, (ii) customer identification, (iii) ongoing monitoring of higher-risk accounts, and (iv) risk management. While the standards have been widely adopted as a benchmark for good practice by financial institutions, in many jurisdictions legal restrictions that impede effective cross-border sharing of information still need to be removed to facilitate consolidated KYC risk management processes.

In December, following earlier press releases on the potential impact of the implementation of international financial reporting standards (IFRS) on regulatory capital, the BCBS issued a release encouraging national supervisors to consider an additional set of related issues. Some recommendations cover the regulatory capital treatment of gains and losses on available-for-sale instruments under IAS 39. The Committee also recommends that caution be exercised if national supervisors allow partial recognition of unrealised gains on both own-use and investment properties in Tier 2 capital. In the context of exposure measurement, the Committee also suggests that the exposure amount of an asset for risk weighting purposes should be defined as no less than the amount by which regulatory capital would be reduced in the event of a
full write-off. Finally, the Committee announced that it will continue to consider the potential effects of the use of fair value option accounting under IAS 39.

As part of another follow-up to the revised capital adequacy framework (Basel II), the BCBS announced that several member countries had decided to conduct national impact studies or field tests based on Basel II during 2004 or 2005. Unlike the quantitative impact studies (QIS)\(^1\) conducted before the release of Basel II in June 2004, these exercises do not represent a joint effort of the Committee. The main motivation behind these national efforts is the fact that, since the release of the revised framework, banks’ ability to estimate the parameters for the more advanced approaches of Basel II has improved significantly. In addition, certain analyses conducted by the Committee after the last QIS had been based on approximations, due to a lack of more accurate data.

**Committee on the Global Financial System**

In January, the Committee on the Global Financial System (CGFS) issued a report that highlights several of the characteristics of structured products, challenges for rating agencies in this area, and implications for central banks and investors. Entitled *The role of ratings in structured finance: issues and implications*, the report was prepared by the CGFS Working Group on Ratings in Structured Finance and seeks to identify and explain methodological differences between the rating of structured finance instruments and of more traditional credit products. In addition, it explores the various methodological and organisational challenges involved in rating structured finance products. Documenting the Working Group’s findings, the report complements earlier work by the CGFS and the Joint Forum.\(^2\)

Also in January, the Committee published a report entitled *Stress testing at major financial institutions: survey results and practice*, which summarises the findings of a survey on stress tests undertaken by banks and securities firms. The report reviews what financial institutions perceive to be the main risk scenarios (based on the type of stress tests they are running), explores some of the structural aspects of stress testing and examines how practices have evolved since the 2001 CGFS survey on stress tests.\(^3\) The results of the survey indicate that stress tests based on movements of interest rates and credit events were the most dominant types of tests performed, with the majority of tests focusing on markets in more than one region. The report concludes that, while stress testing is becoming an integral part of the risk

---

1. The main purpose of the QIS was to gather information in order to assess whether the Committee had met its goal with regard to the revised framework.


## Main recent initiatives by Basel-based committees and other bodies

Press releases and publications over the period under review

<table>
<thead>
<tr>
<th>Body</th>
<th>Initiative</th>
<th>Thematic focus</th>
<th>Release date</th>
</tr>
</thead>
</table>
| BCBS         | Consolidated KYC paper                                                      | • Importance of banks’ managing “know-your-customer” risk on a global consolidated basis  
• Complement to earlier BCBS report *Customer due diligence for banks*  
• Identifies key elements for effective management of KYC risk throughout a banking group | October 2004 |
|              | Press release on capital treatment of certain items under international financial reporting standards (IFRS) | • Impact on regulatory capital  
• Points for national supervisors to consider when implementing IFRS | December 2004 |
|              | Basel II: national quantitative impact studies announced                    | • Post-release estimation advances as motivation for national field tests on impact of Basel II  
• Not a joint effort of the BCBS, but based on a common template |              |
| CGFS         | The role of ratings in structured finance: issues and implications           | • Characteristics of structured products  
• Challenges for rating agencies and other market participants  
• Implications for central banks | January 2005 |
|              | Stress testing at major financial institutions: survey results and practice  | • Review of major risks perceived by financial institutions  
• Examines evolution of stress testing practices |              |
| CPSS         | Statistics on payment and settlement systems in selected countries – Figures for 2003 | • Annual release of country-specific and comparative tables | October 2004 |
|              | Recommendations for central counterparties (CCPs)                          | • Risk management standards for CCPs  
• Recommendations and implementation methodology | November 2004 |
|              | Payment systems in Sri Lanka                                               | • Red Book series publication | December 2004 |
| Joint Forum¹ | Report on credit risk transfer (CRT)                                       | • Degree of risk transfer achieved by instruments/transactions  
• Agents’ understanding of risks involved  
• Concentration risk due to CRT | October 2004 |

¹ 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).

Sources: www.bis.org; www.fsforum.org.
management frameworks of financial institutions and works as a complement to other risk management tools like value-at-risk, a number of challenges remain. The report also notes that there is an interest in developing better stress tests incorporating loan portfolios.

Committee on Payment and Settlement Systems

In October, the Committee on Payment and Settlement Systems (CPSS) released its annual publication of statistics on payment and settlement systems in the 13 member countries. The report contains detailed tables on various aspects of payment systems for each individual country as well as a number of comparative tables which document a variety of issues such as the relative importance of cashless payment instruments or the features of selected interbank funds transfer systems.

In November, the CPSS and the Technical Committee of the International Organization of Securities Commissions (IOSCO) released a report that sets out comprehensive standards for risk management of a central counterparty (CCP), an entity that interposes itself between counterparties in financial transactions. While a well managed CCP reduces the risks faced by its participants, it also presents a potential threat to the goal of financial stability since it exposes the securities settlement system to increased levels of concentration risk. Entitled Recommendations for central counterparties, the report features 15 headline recommendations and accompanying explanatory text, covering the major types of risks CCPs face such as counterparty credit risk, liquidity risk, settlement bank risk, custody risk, operational risk and legal risk. The report also includes a methodology for assessing the implementation of the recommendations.

In December, as one of its periodic reference works on payment systems in various countries, the CPSS published a “Red Book” for Sri Lanka. Payment systems in Sri Lanka have undergone significant reforms over the last few years. These include the introduction of an RTGS system in 2003 and the successful launch of a government securities settlement system in 2004. This national report offers a detailed documentation of the key importance of properly functioning payment systems for enhancing the stability of the financial system.

Joint Forum

In response to a request by the Financial Stability Forum (FSF), in October the Joint Forum’s Working Group on Risk Assessment and Capital published a report entitled Credit risk transfer. The report focuses on three issues highlighted by the FSF: whether instruments and transactions accomplish a clean transfer of risk, the degree to which market participants understand the risks involved, and whether credit risk transfer activities are leading to undue

---

concentrations of credit risk. It concludes that credit derivatives have achieved a relatively good risk transfer record to date. Market players seem to be largely aware of the risks concerned, and the concentrations of credit risk pose no immediate threat to financial stability.

Financial Stability Forum

The FSF, in conjunction with the International Accounting Standards Board and the International Federation of Accountants, held a roundtable in October to identify issues and challenges arising in the adoption and implementation of IFRS and international standards on auditing. The participants, including national authorities with responsibility for financial reporting, accounting and auditing associations, accounting and auditing standard setters, market participants, international regulatory bodies and development agencies, focused on the following issues in particular: (i) the importance of well developed accounting and auditing regulatory frameworks to ensure effective implementation of standards; (ii) implications for the breadth of implementation of IFRS reporting arising from the complexity of the standards, the need for translations, and variations in the demand for financial information across different firm types (such as small and medium-sized enterprises); (iii) the need to balance the volume and frequency of changes to the standards against a desire for a stable platform to facilitate implementation; (iv) the lack in some jurisdictions of capacity for rapid and complete implementation; (v) the challenges associated with achieving commonality in the application of standards in the absence of consistent interpretation from standard setters and enforcers, and, related to that, the appropriate posture for enforcers in the first years of application of the new standards; and (vi) the importance of effective communication between reporters and end users of financial information to minimise volatility in the adoption period.

Attendees welcomed the willingness of the FSF and the coorganisers to arrange a similar gathering, once the new standards have been introduced, to review developments.