

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

For most of 2004, the endorsement of the new capital adequacy framework (Basel II) and issues related to its implementation were the dominant themes. The first quarter of 2005, however, was characterised by more diverse releases by the various Basel-based committees and the Financial Stability Forum. The formal establishment in February 2005 of the Public Interest Oversight Board (PIOB) – a result of multilateral efforts in the oversight of international accountancy standard setting – represents a special highlight of the period under review. Table 1 provides a selective overview of the most recent initiatives.

Basel Committee on Banking Supervision

BCBS publishes study focusing on empirical methods to validate internal rating systems ...

In January, the Basel Committee on Banking Supervision (BCBS) provided an update on one of the greatest challenges of implementing the new capital adequacy framework, the need to validate the systems used to generate the parameters that serve as inputs to the internal ratings-based (IRB) approach to credit risk. This work is carried out under the aegis of the Committee's Accord Implementation Group (AIG) and focuses on the essential role that internal ratings and default and loss estimates play in the credit approval, risk management, internal capital allocation and corporate governance functions of banks using the IRB approach. Recognising that validation is a fundamental aspect of this approach, the AIG has established a subgroup to examine a range of issues related to validation. In this context, the BCBS in February issued a working paper on key aspects of the validation process. Entitled *Studies on the validation of internal rating systems*, the paper presents the work of the Validation Working Group, a subgroup of the Committee's Research Task Force (RTF). The paper concentrates on the validation of the three key risk components in the regulatory capital calculation: probability of default (PD), loss-given-default (LGD) and exposure at default (EAD).

... and announces plans to undertake QIS 5

In March, as part of another follow-up to Basel II, the Committee announced plans to undertake the fifth Quantitative Impact Study

(QIS 5)¹ between October and December 2005 in order to ensure that the review of the calibration of the revised framework, scheduled to take place in spring 2006, is based on the most recent, high-quality data. In addition, QIS 5 will help to evaluate the impact of the Committee's new proposals for the recognition of the effect that both a borrower and a guarantor must default on the same obligation for a loss to be incurred (double default) and trading book-related issues, which were released in a paper for public comment in April.² Entitled *The application of Basel II to trading activities and the treatment of double default effects*, the paper proposes capital requirements that are intended to improve the sensitivity of the capital rules to the underlying economic risks associated with such exposures in a Basel II-compatible fashion. The paper addresses the treatment of the following five issues in particular: (i) counterparty credit risk for over-the-counter (OTC) derivatives and repos; (ii) the double default effect for covered exposures; (iii) the short-term maturity adjustment for trading book-related items under the IRB approach; (iv) improvements to the current trading book regime; and (v) the design of a specific capital treatment for unsettled and failed transactions.

Also in April, the BCBS issued a high-level paper entitled *Compliance and the compliance function in banks*. The paper aims to provide basic guidance for banks based on the views of banking supervisors on compliance. Relying on a single framework of principles, the paper illustrates how compliance with the laws, rules and standards that govern banking activities helps to maintain a bank's reputation vis-à-vis its shareholders, customers, employees and the markets.

BCBS paper on compliance function provides guidance

Committee on the Global Financial System

In February, the Committee on the Global Financial System (CGFS) announced that – under its auspices – the ECB, in cooperation with the Bank of Japan and the Board of Governors of the Federal Reserve System, would host a conference on risk measurement and systemic risk. Scheduled to take place in early November 2005, this fourth in a series of *Joint central bank research conferences on risk measurement and systemic risk* will focus on questions relating to sources of financial contagion and its relation to other forms of systemic risk, macro stress testing, the financial stability implications of credit risk transfers (CRT) and recent advances in risk measurement.³

CGFS announces joint central bank conference on risk measurement

¹ The main purpose of the QIS to date has been to gather information with which to assess whether the Committee has met its goals with regard to the revised framework.

² A summary of responses received on a survey of banks' and investment firms' trading books that provides background material was also published in April (see Basel Committee on Banking Supervision, *Trading book survey: a summary of responses*, 2005).

³ A detailed conference outline and more information on the call for papers are available at www.bis.org/cgfs/cgfsconf2005.htm.

Main recent initiatives by Basel-based committees and other bodies			
Body	Initiative	Thematic focus	Release date
BCBS	<i>Studies on the validation of internal rating systems</i>	<ul style="list-style-type: none"> Importance of validation of systems used to generate the parameters for IRB approach Empirical validation methods with regard to probability of default (PD), loss-given-default (LGD) and exposure at default (EAD) 	February 2005
	Schedule for QIS 5	<ul style="list-style-type: none"> Key input for review of calibration of Basel II Evaluation of impact of new proposals (trading book-related issues and double default) 	March 2005
	<i>The application of Basel II to trading activities and the treatment of double default effects</i>	<ul style="list-style-type: none"> Consultation paper for public comments prepared by joint BCBS-IOSCO working group Outline of proposals for capital requirements dealing with trading book-related issues and double default 	April 2005
	<i>Compliance and the compliance function in banks</i>	<ul style="list-style-type: none"> Basic guidance for banks Single framework incorporating sound practice guidance for design, implementation and operation of compliance function 	
CGFS	Fourth joint central bank research conference on risk measurement and systemic risk	<ul style="list-style-type: none"> Conference announcement and call for papers Financial contagion, macro stress testing, financial stability implications of credit risk transfers, advances in risk measurement techniques 	February 2005
CPSS	<i>Statistics on payment and settlement systems in selected countries – Figures for 2003</i> (final version)	<ul style="list-style-type: none"> Annual release of country-specific and comparative tables 	March 2005
Joint Forum ¹	Update on initiatives to combat money laundering and the financing of terrorism	<ul style="list-style-type: none"> Update on activities by BCBS, IAIS and IOSCO 	January 2005
	Outsourcing guidance to the financial sector (final version)	<ul style="list-style-type: none"> Guiding principles, current trends Regulatory developments, key risks 	February 2005
	Report on credit risk transfer (CRT) (final version)	<ul style="list-style-type: none"> Degree of risk transfer achieved by instruments/transactions Agents' understanding of risks involved Concentration risk due to CRT 	March 2005

FSF	Establishment of PIOB	<ul style="list-style-type: none"> • Joint initiative by BCBS, FSF, IAIS, IOSCO and World Bank • To oversee public interest activities of the International Federation of Accountants (IFAC) 	February 2005
	Thirteenth meeting and progress report	<ul style="list-style-type: none"> • Financial system vulnerabilities • Transfer of risk to the household sector • Issues relating to prior concerns • New process to promote improvements in offshore financial centres 	March 2005
<p>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).</p> <p>Sources: www.bis.org; www.fsforum.org.</p>			

Table 1

Committee on Payment and Settlement Systems

In March, the Committee on Payment and Settlement Systems (CPSS) released the final version of its annual publication of statistics on payment and settlement systems in the 13 member countries.⁴ The report contains detailed tables on various aspects of payment and securities settlement systems for each individual country as well as a number of cross-country comparative tables.

CPSS releases annual statistics on payment and settlement systems

Joint Forum

In January, the Joint Forum published an update on the various initiatives taken by the respective sectors (banking supervisors, insurance supervisors and securities commissions) to combat money laundering and the financing of terrorism. This note had been prepared for the November 2004 meeting of the Joint Forum. It was intended as an overview of developments since the June 2003 report, entitled *Initiatives by the BCBS, IAIS and IOSCO to combat money laundering and the financing of terrorism*.

Joint Forum issues update on various initiatives ...

In February and March, the Joint Forum released the final versions of two separate reports for which the consultative documents had been circulated during the latter half of 2004.⁵ The first report, entitled *Outsourcing in financial services*, recognises the global trend whereby internationally active businesses providing financial services are 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

... releases final report on outsourcing in financial services ...

⁴ See Committee on Payment and Settlement Systems, *Statistics on payment and settlement systems in selected countries – Figures for 2003, 2005*. The preliminary version, published in October 2004, included some data for 2003 that were provisional.

⁵ The consultative document *Outsourcing in financial services* was issued in August 2004 and the one entitled *Credit risk transfer* in October 2004 (see this chapter of the December 2004 *BIS Quarterly Review*).

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 also issues final report on credit risk transfer

The second report, entitled *Credit risk transfer*, was prepared by the Joint Forum's Working Group on Risk Assessment and Capital in response to a request by the Financial Stability Forum (FSF). 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

Public Interest Oversight Board established to oversee IFAC

In February, the Financial Stability Forum (FSF) together with IOSCO, the BCBS, the IAIS and the World Bank announced the formal establishment of the Public Interest Oversight Board (PIOB). The PIOB will oversee the International Federation of Accountants' (IFAC) standard-setting activities relating to auditing and assurance practices and member body compliance programmes. The establishment of the PIOB is the result of a collaborative effort by the international financial regulatory community to ensure that the auditing standards set by IFAC and its committees are in line with public interest. As such, this new body will strengthen international auditing standards through informed oversight and by enhancing the transparency and consultative processes involved in these activities.

In March, the FSF held its 13th meeting in Tokyo. The issues discussed included: risks and vulnerabilities in the international financial system; the transfer of risk to the household sector; offshore financial centres; financial reporting and audit-related matters; international standards, codes and best practices; and reinsurance.

FSF reviews risks to financial stability ...

With regard to *vulnerabilities in the international financial system*, the FSF noted that the near-term outlook for global growth and inflation, and the current balance sheet strength of financial institutions, provided a positive backdrop for financial stability. However, members identified a number of risks with the potential to cause strains in financial systems, including: the current level of global funding and market liquidity and the associated low levels of risk premia and long-term interest rates; the process of unwinding global current account imbalances; the continued tightness of commodity markets; and possible spillovers to other economies from future capital account or economic

developments in China. Members also discussed the continued rapid growth of the hedge fund sector and the systemic importance of hedge funds' counterparty relationships.

FSF members thought that major banks and securities firms seemed well placed to manage any potential changes in the economic and financial environment. Nonetheless, members encouraged market participants to monitor and manage evolving risks closely, including through stress-testing of exposures to more adverse scenarios.

On the *transfer of risk to the household sector*, the FSF noted the growing extent of such risk transfer and discussed the changes in financial tools and risk exposures under way on both the asset and liability sides of household balance sheets. Members highlighted the need to foster the financial education of households and ensure that risks were well managed.

On *offshore financial centres (OFCs)*, the FSF agreed on a new process, based on objective criteria and due process, to promote further improvements, notably in the areas of cross-border cooperation and information exchange and adequacy of supervisory resources. At the same time, members agreed that the list of OFCs issued by the FSF in 2000 had served its purpose and was no longer operative. The new process includes initiatives by Forum members at both international and national levels and steps by the FSF itself. The FSF will establish a group to review reports by IOSCO, the IMF and other bodies on the status of their efforts and the results that have been achieved. Drawing on the advice of this group, the FSF will consider follow-up actions as necessary, either to recognise improvements or to highlight non-cooperation with ongoing assessment processes. Unless other considerations call for acceleration of the process, the FSF will in two years' time review the adequacy of these initiatives in addressing the current concerns of its members.

... agrees to improve cross-border information exchange on offshore financial centres ...

With regard to *financial reporting and audit-related matters*, the FSF welcomed the establishment in February 2005 of the Public Interest Oversight Board (PIOB). It also noted progress towards international convergence in accounting standards and encouraged a positive outcome in connection with the finalisation of IAS 39 and other important conceptual accounting issues.

On *international standards, codes and best practices*, the FSF discussed a report by an IOSCO Chairmen's Task Force on IOSCO's response to recent high-profile incidents of securities fraud and market abuse. The FSF agreed to review progress at its next meeting and also issues with respect to implementation of standards and codes more generally. As input to that discussion, in April the FSF Secretariat, with the IMF and World Bank, convened a meeting of standard setters, assessors, and others involved with standards and codes to refine the issues that could usefully be addressed. The IMF's and World Bank's own forthcoming review of standards and codes will also provide input to the FSF discussion.

... discusses a report on international standards and best practices ...

On *reinsurance*, the FSF welcomed publication by the IAIS in December 2004 of the first global reinsurance market report. The report highlighted the improving overall financial strength of the industry during 2003. Members encouraged the IAIS to further develop data collection and analysis of the structure and resilience of the sector.

... and welcomes IAIS report on reinsurance

Members also discussed *work in other areas*, including: a Joint Forum group examining financial institutions' risk management practices concerning liquidity risk; another Joint Forum group seeking to develop high-level principles on business continuity for financial authorities and market participants; and a task force co-chaired by the CPSS and World Bank to establish general principles on international remittances.