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Recent initiatives by the Basel Committee on Banking Supervision, the Financial Stability Forum and the Group of Ten

In the third quarter of 2005, the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Forum (FSF) took a variety of initiatives. In addition, the G10 released a report on the implications for financial markets and economic policies of ageing and pension system reform. The G10 discussed this report and other issues at a meeting in late September. Table 1 provides a selective overview of these recent developments.

Basel Committee on Banking Supervision

The BCBS made further progress towards the implementation of Basel II. In particular, clarification was provided regarding the validation of low-default portfolios, and there was further advancement in the area of the fifth Quantitative Impact Study.

Clarification regarding the validation of low-default portfolios

The Basel Committee Accord Implementation Group's Validation Subgroup (AIGV) set forth views regarding the *validation of low-default portfolios in the Basel II framework.* They were released in a newsletter on 5 September, in response to questions and comments received from the industry. While confirming that Basel II is generally flexible enough to allow banks to meet the minimum internal ratings-based (IRB) qualifying criteria for all types of portfolios, the document clarifies the appropriate treatment in the IRB approaches of portfolios where banks may have limited loss data. The note summarises the various methods and tools available to compensate for such data scarcity, and underlines the implications for supervisors.

Release of new materials on QIS 5

Furthermore, additional guidance was provided on the *fifth Quantitative Impact Study (QIS5).* It comprised templates for the QIS 5 workbook, accompanying instructions (based on the drafts published in July), a data quality questionnaire, and a compilation of frequently asked questions. While the structure of the workbooks used for the QIS 5 data collection exercise will be the same in all participating countries, national supervisory agencies will have discretion to adjust the forms to reflect country practices.

Financial Stability Forum

The FSF held its *14th meeting in London* on 8–9 September. Members discussed risks and vulnerabilities in the international financial system and current efforts to enhance financial system resilience. On this occasion, the FSF also exchanged views with a group of financial market practitioners on financial markets and institutions, and on private sector work under way to strengthen financial system stability.

Potential sources of strain in financial markets

The economic and financial context appeared generally benign, and financial systems had weathered several challenges over the previous six months. But high oil prices, low risk premia, low long-term interest rates, increased exposures to complex and illiquid products, rising household indebtedness and persistent or growing external and fiscal imbalances were seen as issues that might over time lead to strains in financial markets.

Despite recent progress, need to further improve industry practices

In the light of these developments, it was considered particularly important that market practitioners, supervisors and policymakers take an appropriately medium-term view of risks and pay particular attention to ensuring the adequacy of market discipline, credit and operational standards, and levels of provisioning. While it was recognised that financial institutions had made significant advances over the past few years in risk management practices and that market infrastructure had been strengthened, structural changes in markets, the presence of new market participants, the growing complexity of financial products, as well as the important role of large complex financial institutions, pointed to the need for sustained improvements. In this context, the FSF welcomed the report of the Counterparty Risk Management Policy Group II and strongly endorsed its recommendations for reviewing and strengthening industry practices.

Lessons from past episodes of market illiquidity

Members also discussed past disruptions to market liquidity and the lessons that could be drawn from them with a view to resolving potential future episodes of market illiquidity. The importance of stress testing was emphasised in this connection.

The FSF also reviewed ongoing work to mitigate sources of vulnerability, particularly with regard to convergence and dialogue on accounting and auditing issues, progress on the implementation of standards and codes and on strengthening standard-setting processes, promoting improvements in offshore financial centres, and the development of a set of high-level business continuity principles. Members also received an update from the International Association of Insurance Supervisors (IAIS) concerning work to develop supervisory guidance on finite risk reinsurance.

Chairman Ferguson reported on the FSF meeting to the International Monetary and Financial Committee on 24 September in Washington DC.

Group of Ten

Recent changes to pension systems …

At the request of its Deputy Ministers and Governors, the G10 prepared a *report on ageing and pension system reform, and the implications for financial markets and economic policies*. The report highlights the ways in which retirement schemes are currently changing, in the context of ageing

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	*Validation of low-default portfolios in Basel II*	• Clarification on the appropriate treatment in the IRB approaches of portfolios where banks may have limited loss data	September 2005
	Further guidance on QIS 5	• Release of QIS 5 workbook templates, accompanying instructions, data quality questionnaire, and FAQs	
FSF	*Fourteenth FSF meeting held in London*	• Discussion of current financial system strengths and vulnerabilities and of ongoing work to enhance system stability. Particular focus on risk management practices, lessons from past market liquidity crises, implementation of standards and codes, accounting and auditing issues, and reinsurance	September 2005
Group of Ten[1]	*Report on ageing and pension system reform; meeting of finance ministers and central bank Governors*	• Ageing and pension system reform: implications for financial markets and economic policies	September 2005

[1] Giulio Tremonti, Minister of the Economy and Finance of Italy, was elected Chairman of the G10 for the coming year.
Source: Relevant bodies' websites (www.bis.org and www.fsforum.org). Table 1

populations. In particular, it notes the increased reliance on private (as opposed to official) retirement saving schemes, and in some cases a shift from defined benefit to defined contribution schemes. The changes under way in public and private pension schemes, and the greater role of pension funds, may increase significantly the influence of retirement saving and related capital flows in financial markets. For instance, given the large and growing size of pension funds' portfolios, shifts in asset allocation in response to the evolution of their own investment strategies or to accounting and regulatory changes could affect the level and volatility of asset prices.

… and their impact on financial markets

The policy conclusions of the report relate to (i) supervision and regulation, (ii) the supply of suitable financial instruments, and (iii) the protection of pension beneficiaries and financial education. First, regulators and supervisors have a role to play by setting out standards to enhance risk management, transparency, governance and accounting standards at pension funds, as well as promoting consistency between funding and prudential requirements.[1] Second, governments could promote the development of financial market segments – particularly for very long-dated and index-linked bonds or payout instruments such as annuities and flexible real estate products

Policy implications for supervision and regulation …

… for the development of long-term instruments …

[1] This might be achieved with appropriate tax incentives.

– that will be useful for retirement savings and the provision of retirement benefits. Third, as risks are increasingly being shifted to individual households, the protection of pension beneficiaries, and the need to improve financial education and the provision of advice, were highlighted as important issues.

… and for the protection of pension beneficiaries

Ministers and Governors of the G10 discussed the report at their meeting on 25 September. Generally, they noted that policy responses can involve trade-offs, such as between free choice of investments and effective prudential control or between maximising returns and ensuring secure retirement incomes. Striking the right balance between such competing objectives is largely a matter of social preference, and it is not to be expected that all countries will make the same choices.