

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

The various Basel-based committees and the Financial Stability Forum (FSF) took a number of initiatives during the first quarter of 2006. The FSF organised a roundtable on financial reporting and auditing, and held two other meetings. The Basel Committee on Banking Supervision (BCBS) released guidance on enhancing corporate governance for banking organisations and issued consultative documents on the Core Principles for Effective Banking Supervision and the related methodology. The Committee on Payment and Settlement Systems (CPSS) announced the preparation of a survey of foreign exchange settlement risk, agreed to set up a working group on clearing and settlement arrangements for OTC derivatives, and issued a consultative report on general principles for international remittance services. Table 1 provides a selective overview of these and other recent initiatives.

Financial Stability Forum¹

In the first quarter of 2006, the FSF organised – jointly with two accounting bodies – a roundtable on financial reporting and auditing. It also held a regional and a regular plenary meeting, both in Sydney, Australia.

FSF organises roundtable on financial reporting and auditing

The roundtable, co-organised with the International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC), addressed experiences with the first year of implementation of the International Financial Reporting Standards (IFRS); the convergence process between the IASB and other national accounting standard setters; fair value accounting issues; and risks in the financial reporting chain. Taking part were 78 senior participants from national authorities with responsibility for financial reporting; accounting and auditing professional organisations; accounting and auditing standard setters; market participants, including representatives from capital market firms, corporations and investors; international regulatory bodies; and international financial institutions. While investor confidence in the financial reporting process has improved in recent years, roundtable participants agreed

¹ On 21 April 2006, it was announced that Mario Draghi, Governor of the Bank of Italy, would succeed Roger Ferguson as Chairman of the FSF. Mr Ferguson was to step down at the end of April.

that confidence needed to be further enhanced. Complexity in business structures, in the character of transactions and in accounting standards remains a source of ongoing risk for capital markets. There were also concerns about audit firm concentration risk and the quality and consistency of audits across global audit firm networks. The roundtable recognised the potential benefits that many see in a long-term movement by the IASB towards fair value accounting, but also the continued concerns of many others about the reliability, verifiability and relevance of fair value estimates for non-traded items.

On 16 March, the FSF held its *fourth Asia-Pacific regional meeting* in Sydney, Australia. Participants discussed the outlook for the global and regional economies, the role of foreign-owned financial institutions in strengthening financial stability, the potential impact of an avian flu pandemic on economies and financial systems, and progress towards convergence and harmonisation in international accounting standards. They also shared experiences with the promotion of domestic bond markets and discussed the role of assessments against international standards in aiding the prioritisation of financial sector reforms.

The outlook for the global and regional economies was seen to be favourable, with external demand and accommodative financial conditions in recent years supporting growth and financial markets in the Asia-Pacific region. These conditions, together with a build-up of foreign exchange reserves, the adoption of more flexible exchange rate arrangements and strengthened financial systems, had enabled countries in the region to reduce external vulnerabilities. They had supported efforts to strengthen local financial and corporate sector balance sheets, although the pace of progress varied from country to country. Regulatory and supervisory frameworks had been enhanced. Nevertheless, participants highlighted several challenges, relating inter alia to high oil and other commodity prices and to investors' appetite for risk. While currently low credit spreads in large part reflected improved fundamentals, a sudden reversal in risk appetites, especially if accompanied by unexpected increases in global bond yields or a sharp rise in asset price volatility, could alter the positive outlook for financial stability.

In the context of concerns about persistent global imbalances, participants noted efforts by authorities in the region to increase domestic absorption, through stronger domestic consumption and investment, and intentions elsewhere to increase national savings. While household consumption was being supported in several regional economies by bank lending, it was also viewed as important for institutions to assess carefully the risks arising from such lending to ensure it did not jeopardise stability. With regard to investment, including for needed infrastructure, it was pointed out that, despite a number of national and regional initiatives under way to foster the development of domestic corporate bond markets, further progress could be made. This would be desirable in order to diversify funding sources and complement bank lending.

At its fourth Asia-Pacific regional meeting, FSF notes reduced external vulnerabilities ...

... although challenges remain

Efforts to increase domestic absorption in Asia

Main initiatives by Basel-based committees and other bodies

Press releases and publications over the period under review

Body	Initiative	Thematic focus	Release date
FSF	Roundtable on financial reporting and auditing	<ul style="list-style-type: none"> Initial experiences, successes, challenges and implications for the global financial system witnessed in the first year of implementation of IFRS. Increased use of fair values for financial reporting purposes; convergence, harmonisation and reconciliations; possible risks and vulnerabilities. 	February 2006
	<i>Fourth Asia-Pacific regional meeting</i>	<ul style="list-style-type: none"> Outlook for the global and regional economies. Efforts to increase domestic absorption in Asia. Role of foreign-owned financial institutions in strengthening financial stability. Potential impact of an avian flu pandemic. Progress towards convergence and harmonisation in international accounting standards. Experiences with strengthening financial systems. 	March 2006
	<i>Fifteenth FSF meeting in Sydney</i>	<ul style="list-style-type: none"> Global risks and vulnerabilities. Counterparty risk management, settlement and valuation practices for complex financial instruments. Avian flu. International standard-setting processes. Concerns about regulatory overload. Ongoing work to mitigate sources of vulnerability. 	
BCBS ¹	<i>Enhancing corporate governance for banking organisations</i>	<ul style="list-style-type: none"> Update of 1999 guidelines, incorporates comments received on consultative version of July 2005. 	February 2006
	<i>Use of vendor products in the Basel II IRB framework</i>	<ul style="list-style-type: none"> Supervisory expectations on how banks might satisfy IRB validation requirements when using vendor products; focus on identification, documentation, understanding, suitability and reviewing. 	March 2006
	Consultative document on <i>Core Principles for Effective Banking Supervision</i>	<ul style="list-style-type: none"> Revised version of Core Principles published in 1997. 	April 2006
	Consultative document on <i>Core Principles Methodology</i>	<ul style="list-style-type: none"> Revised version of Methodology issued in 1999. 	
CPSS	<i>Survey of foreign exchange settlement risk</i>	<ul style="list-style-type: none"> Part of a comprehensive strategy to reduce systemic risks inherent in foreign exchange transaction settlement arrangements. Updates surveys of 1996 and 1997. 	February 2006
	<i>CPSS working group on clearing and settlement arrangements for OTC derivatives</i>	<ul style="list-style-type: none"> Existing arrangements and risk management practices in the broader OTC derivatives market, risk mitigation role of market infrastructure. 	
	Consultative report on <i>general principles for international remittance services</i>	<ul style="list-style-type: none"> Payment system aspects of international remittance services, general principles for improving this market. 	March 2006

¹ Mr Nout Wellink, President of the Netherlands Bank, was appointed the new Chairman of the BCBS, effective 1 July 2006.

Source: Relevant bodies' websites (www.bis.org and www.fsforum.org).

Table 1

Participants also discussed the role played by foreign-owned financial institutions in strengthening domestic financial systems, and the associated need for effective coordination and information exchange between home and host supervisors.

The role of foreign-owned financial institutions

Meeting attendees shared their assessments of the potential impact of an avian flu pandemic on their economies and financial systems. They agreed on the need for business continuity planning – in particular with a view to maintaining the operation of payment systems – and stressed the importance of effective communication in the event of a pandemic. They also discussed where there was scope for risk-mitigating actions by financial authorities.

Business continuity planning in the event of avian flu pandemic

Progress towards convergence and harmonisation in international accounting standards was recognised, along with growing participation from countries in the region. Efforts by the IASB to produce a set of standards for small and medium-sized enterprises, and by regulators and audit oversight authorities to promote more effective cooperation and enhancements to audit quality, were welcomed.

Progress on international accounting standards

Participants also shared experiences with strengthening national financial systems, drawing on lessons learned from the Financial Sector Stability Assessments conducted by the IMF and the World Bank. Assessments against international standards provided useful reference points for reform goals. Prioritisation of reforms was recognised as a particular challenge when countries were faced with multiple reform goals and resource limitations.

The Forum held its *15th regular meeting* on 17 March in Sydney. Members discussed global risks and vulnerabilities, international standard-setting arrangements, concerns about regulatory burden and ongoing work to mitigate sources of vulnerability.

Building on the discussion at the regional meeting on the previous day, participants noted that global economic conditions remained benign and that financial systems had weathered a variety of shocks. Balance sheets and capital levels of financial institutions remained strong, while continued structural improvements in markets appeared to have strengthened systemic resilience. However, members pointed to several developments with the potential to cause strains in financial systems, such as further growth in external imbalances, high levels of household sector indebtedness in some countries and low risk premia reflecting a high degree of liquidity and the continuing search for yield in markets. Some areas of ongoing concern were reviewed, including issues related to counterparty risk management, hedge funds, operational risks and valuation practices for complex financial instruments. While progress had been made in addressing confirmation backlogs and issues related to the assignment of credit derivative contracts, the FSF noted that further work was needed to implement the recommendations of the Counterparty Risk Management Policy Group II, notably with respect to operational risks and issues of transparency with regard to credit derivatives. The FSF urged firms to further strengthen their risk management practices, including the comprehensiveness of their stress testing and scenario analysis.

At its 15th regular meeting, FSF takes stock of benign global economic conditions ...

... while pointing to potential strains in financial systems

The FSF reviewed the practices of the key international standard-setting bodies with regard to the transparency, governance and risk focus of their activities. It also considered the challenges, and potential implications for financial stability, of a recent series of international, regional and national regulatory initiatives. Members noted the desirability of continued dialogue with the private sector on regulatory initiatives. The discussion of ongoing work to mitigate sources of vulnerability focused on cross-border information exchange in financial disruptions and business continuity incidents, offshore financial centres, IFRS and auditing issues, reinsurance and funding liquidity risk management practices.

Basel Committee on Banking Supervision

In February 2006, the BCBS released guidance on enhancing corporate governance for banking organisations. In March, it provided clarification on the use of vendor products in the Basel II IRB framework, and in April it issued consultative documents on *Core Principles for Effective Banking Supervision* and on the *Core Principles Methodology*.

BCBS releases guidance for enhancing corporate governance for banking organisations ...

Corporate governance has continued to attract considerable national and international attention in the light of a number of high-profile breakdowns in governance processes. *Enhancing corporate governance for banking organisations* incorporates comments received on a consultative paper issued in July 2005.² After the OECD published revised corporate governance principles in 2004, the BCBS recognised that revised guidance could also assist banking organisations and their supervisors in the implementation and enforcement of sound corporate governance. Accordingly, it published this revision to its 1999 text in order to offer practical guidance relevant to the unique characteristics of banking organisations. Particular focus is placed on activities of banking organisations conducted through structures which may lack transparency, or in jurisdictions that pose impediments to information flows.

... and provides clarification on the use of vendor products in the Basel II IRB framework

In a newsletter published in March 2006, the Committee provided clarification on the *use of vendor products*³ in the *Basel II IRB framework*. This newsletter sets forth the views of the Basel Committee Accord Implementation Group's Validation Subgroup (AIGV) relating to the use of vendor products within internal ratings-based (IRB) approaches of the Basel II framework. The AIGV developed the newsletter in response to industry questions about supervisory expectations for incorporating vendor products into banks' IRB processes. The purpose was to further elaborate on supervisory expectations regarding how banks might satisfy IRB validation requirements when vendor products, which frequently introduce information transparency issues, are used within banks' IRB processes. The AIGV benefited from recent meetings with

² See "Recent initiatives by Basel-based committees and the Financial Stability Forum", *BIS Quarterly Review*, September 2005.

³ Models and datasets developed by vendors and used within the context of banks' IRB processes to assign exposures to certain rating grades, or segments, or to estimate IRB risk parameters.

various vendors in drafting the document, which focuses on four main points: (i) the need to document and explain the role of vendor products within banks; (ii) the need for banks to have a thorough understanding of such products; (iii) ensuring the suitability of the products for the banks' exposures and risk rating methodologies, and for use within the IRB framework; and (iv) the importance of strategies for reviewing the performance of the products on a regular basis.

In April 2006, the BCBS issued for comment by 23 June 2006 consultative documents on the *Core Principles for Effective Banking Supervision* and the associated *Core Principles Methodology*. The Principles were originally published by the Committee in September 1997. Along with the methodology, first issued in 1999, the Core Principles have been used by countries as a benchmark for assessing the quality of their supervisory systems and for identifying future work needed to achieve a baseline level of sound supervisory practices. Since 1997, however, significant changes have occurred in banking regulation, and much experience has been gained with implementing the Core Principles in individual countries. Moreover, new regulatory issues, insights and gaps in regulation have become apparent, often resulting in new Committee publications. These developments have made it necessary to update the Core Principles and the associated methodology, the latter being a tool designed to improve objectivity and comparability in the assessment of different countries' compliance with the Core Principles. The exercise has been carried out in close cooperation with many non-member supervisors, and there has already been extensive consultation with the regional groups of bank supervisors.

Consultative documents on the Core Principles and the associated methodology

Committee on Payment and Settlement Systems

During the period under review, the CPSS undertook three major initiatives.⁴ It announced the preparation of a survey of foreign exchange settlement risk, agreed to set up a working group on clearing and settlement arrangements for OTC derivatives and issued a consultative report on general principles for international remittance services.

On 1 February 2006, the Committee announced that it would carry out a *survey of foreign exchange settlement risk*, focusing on how banks and other selected institutions manage the risks they can incur when settling foreign exchange transactions. The survey will take place during the second quarter of the year and will invite participation from more than 100 institutions active in the foreign exchange market. Part of a comprehensive strategy⁵ endorsed in

CPSS announces preparation of a survey of foreign exchange settlement risk ...

⁴ In addition, in March 2006, an update was issued for the *Statistics on payment and settlement systems in selected countries – Figures for 2004*. The preliminary version, published in January 2006, did not include some provisional data for 2004, as they were not yet available.

⁵ The strategy involved three tracks: (i) action by individual banks to control their settlement exposures, (ii) action by industry groups to provide risk-reducing multicurrency services, and (iii) action by central banks to induce private sector progress. The G10 central banks reaffirmed this strategy in 2000, emphasising the prime responsibility of the private sector for risk reduction. Since 1996, the CPSS has been monitoring progress in implementing the strategy, including the launch in 2002 of CLS Bank.

1996 by G10 central banks to reduce the systemic risks inherent in foreign exchange transaction settlement arrangements, the current survey is based on those carried out in 1996 and 1997 and has been updated to reflect the significant developments in settlement practices that have since taken place.

... and sets up a working group on clearing and settlement arrangements for OTC derivatives

On 13 February 2006, the CPSS announced that it had agreed to set up a *working group on clearing and settlement arrangements for OTC derivatives*. The working group – comprising representatives of prudential supervisors of major derivatives dealers, as well as CPSS member central banks⁶ – will follow up on a report published by the BIS in 1998 on settlement procedures and counterparty risk management for OTC derivatives. Since 1998, OTC derivatives markets have continued to grow rapidly, with notional amounts outstanding roughly tripling between 1998 and 2004. Furthermore, during that period, market practices have evolved and various enhancements to market infrastructure have been introduced. In this context, the working group will assess the effectiveness of current risk management practices with respect to the post-trade processing infrastructure in OTC derivatives markets, complementing recent supervisory initiatives in some countries relating to assignment practices and confirmation backlogs in credit derivatives markets. The survey will take a comprehensive view of existing arrangements and risk management practices in the broader OTC derivatives market and evaluate the potential for risks to be mitigated by greater use of, and enhancements to, market infrastructure. The working group aims to complete a final report in the first half of 2007.

Consultative report on general principles for international remittance services

In March 2006, the CPSS published a consultative report on *general principles for international remittance services*, aiming to close a gap in the coverage of payment system aspects in other reports on this issue. The report was prepared for the CPSS and the World Bank by a task force consisting of representatives from international financial institutions involved in remittances and from central banks in both remittance-sending and remittance-receiving countries. It analyses the payment system aspects of remittance services and, on the basis of the analysis, sets out general principles designed to assist countries that want to improve this market. The report is open for comments until 18 August 2006.

⁶ Both the Basel Committee on Banking Supervision and the Committee on the Global Financial System will be consulted as the work moves forward.