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Recent initiatives by Basel-based committees[1]

The Basel Committee on Banking Supervision (BCBS) and the Joint Forum announced a number of initiatives during the second quarter of 2006. The BCBS released three guidance papers as well as the results of the fifth Quantitative Impact Study (QIS 5). The Joint Forum published two issues papers.

Basel Committee on Banking Supervision

In June 2006, the Basel Committee on Banking Supervision published three guidance papers as well as the results of the fifth Quantitative Impact Study (QIS 5). The guidance papers, based on consultative documents that had been previously released for public comments, relate to home-host information sharing for effective Basel II implementation, sound credit risk assessment and valuation for loans, and the use of the fair value option.

BCBS releases guidance on home-host information sharing for effective Basel II implementation …

The first guidance paper, on *home-host information sharing for effective Basel II implementation*, highlights the need for home and host supervisors of internationally active banking organisations to develop and enhance pragmatic communication and cooperation with regard to banks' Basel II implementation plans. It was developed jointly with the Core Principles Liaison Group, which includes banking supervisors from 16 non-Committee member countries, the IMF and the World Bank, and draws on a consultative document published in November 2005.[2] The paper aims to make the implementation of Basel II more effective and efficient, so as to conserve scarce supervisory resources and to reduce the burden on the banking industry. In addition to general principles of information sharing in the context of Basel II, the paper also sets out practical examples of information that could be provided by banks, home supervisors and host supervisors.

The paper stresses that, while communication between home and host supervisors is important, banks have a primary role to play in implementing

[1] Donald L Kohn, Vice Chairman of the Board of Governors of the Federal Reserve System, was appointed Chairman of the Committee on the Global Financial System, effective 1 July 2006, succeeding Roger W Ferguson Jr in this capacity.

[2] See "Recent initiatives by Basel-based committees and the Financial Stability Forum", *BIS Quarterly Review*, March 2006.

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	*Home-host information sharing for effective Basel II implementation*	• Revised version of consultative document published in November 2005; general principles for information sharing between home and host country supervisors in implementing Basel II.	June 2006
	Sound credit risk assessment and valuation for loans	• Revised version of consultative document published in November 2005. Provides supervisory expectations for banks and banking supervisors regarding sound credit risk assessment and valuation for loans.	
	Supervisory guidance on the use of the fair value option for financial instruments by banks	• Revised version of the consultative document published in July 2005. Describes supervisory expectations related to using a fair value option for accounting measurements and conducting supervisory evaluations of risk management, controls and capital adequacy for organisations using a fair value option.	
	Results of the *fifth Quantitative Impact Study*	• Evaluates the potential changes in minimum required capital levels under Basel II as the industry progresses toward implementation. Reflects all recent changes to the Basel II framework.	
Joint Forum	*The management of liquidity risk in financial groups*	• Comprehensive study of liquidity risk management practices among 40 of the largest firms in the financial services industry.	May 2006
	Regulatory and market differences: issues and observations	• Cross-sectoral and cross-country comparison of market practices and regulatory approaches to various financial risks.	
Source: Relevant bodies' websites (www.bis.org).			Table 1

Basel II and in providing relevant information to home and host supervisors to allow them to meet their responsibilities. In particular, the local managers of foreign branches and subsidiaries need to be kept informed of the steps that are being taken at group level to manage group capital and of the decision to adopt one option or another under Basel II. In this regard, Basel II does not diminish the legal or governance responsibilities of subsidiary bank management within the group structure.

… and on sound credit risk assessment and valuation for loans

The paper on *sound credit risk assessment and valuation for loans* addresses how common data and processes related to loans might be used for assessing credit risk, accounting for loan impairment and determining regulatory capital requirements. The guidance draws on a consultative document released in November 2005[3] and supersedes *Sound practices for loan accounting and disclosure*, published by the Committee in July 1999. The

[3] See footnote 2.

paper discusses necessary processes for banks in sound credit risk assessment, valuation and control and the responsibilities of boards of directors and senior management to maintain appropriate provisions for loan losses. The paper also provides guidelines for how supervisors should evaluate the effectiveness of a bank's credit risk policies and practices when gauging the appropriateness of its credit risk assessment process, loan loss provisions and regulatory capital. It highlights provisioning concepts that are consistent with prudential and accounting frameworks. As noted in the paper, this supervisory guidance is not intended to set forth additional accounting requirements beyond those established by robust accounting standards.

Particular focus on responsibilities within banks …

The guidance states that banks' boards of directors and senior management are responsible for ensuring that appropriate credit risk assessment processes and effective internal controls are in place that are commensurate with the size, nature and complexity of the banks' lending operations. These processes and controls allow provisions for loan losses to be determined in accordance with the banks' stated policies and procedures, the applicable accounting framework and supervisory guidance. The paper also stresses the need for banks to have a system in place to reliably classify loans on the basis of credit risk, and policies that appropriately address validation of any internal credit risk assessment models. It recommends that banks adopt and document a sound loan loss methodology which addresses credit risk assessment policies, procedures and controls for assessing credit risk, identifying problem loans and determining loan loss provisions in a timely manner; such individual and collectively assessed loan loss provisions should be adequate to absorb estimated credit losses in the loan portfolio. The importance of experienced credit judgment and reasonable estimates is highlighted, together with that of the necessary tools, procedures and observable data to use for assessing credit risk, accounting for impairment of loans and for determining regulatory capital requirements. Banking supervisors should periodically evaluate the effectiveness of a bank's credit risk policies and practices for assessing loan quality and should be satisfied that the methods employed by a bank to calculate loan loss provisions produce a reasonable and prudent measurement of estimated credit losses in the loan portfolio that are recognised in a timely manner. Banking supervisors should consider credit risk assessment and valuation policies and practices when assessing a bank's capital adequacy.

… policies and procedures …

… and the role of supervisors

Fair value option: seven principles structured around two broad categories

The *guidance on the use of the fair value option for financial instruments by banks* results from a consultative document published in July 2005.[4] The guidance is structured around seven principles that fall into two broad categories:

(a) supervisory expectations for banks relevant to the use of the fair value option (regarding compliance with the criteria of IAS 39, the existence of appropriate risk management systems, the exclusion

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

of instruments for which fair values cannot be reliably estimated and the provision of supplemental information by banks);

(b) supervisory evaluation of risk management, controls and capital adequacy.

While this supervisory guidance refers specifically to the fair value option in IAS 39, the principles that it sets forth should be generally applicable to similar fair value option approaches that exist or are being considered in other accounting regimes. National supervisors will need to make this determination based on the criteria and requirements of the fair value option in their jurisdiction.

The guidance is not intended to set forth additional accounting requirements beyond those established by the IASB. Instead, it addresses such matters as bank risk management and capital assessment issues, and thus should not be in conflict with the IASB's accounting and disclosure guidance on the fair value option.

BCBS publishes QIS 5 results and decides to maintain current calibration

On 24 May 2006, the Basel Committee reviewed the calibration of the Basel II framework based on the results of the *fifth Quantitative Impact Study* (QIS 5) and decided to maintain the current calibration. The Committee's Working Group on Overall Capital and Quantitative Impact Study prepared a detailed *report* on the QIS 5 results. The primary objective of the study, which was undertaken in 31 countries, was to allow the Committee to evaluate the potential changes in minimum required capital levels under the Basel II framework as the industry progresses towards implementation. In contrast to previous exercises, the QIS 5 workbooks reflected all recent changes to the Basel II framework, in particular the move to an unexpected loss-only framework for computing risk-weighted assets under the internal ratings-based (IRB) approach, the change in the treatment of reserves, the 1.06 scaling factor applied to credit risk-weighted assets, the recognition of double default and the revised trading book rules.

QIS 5 shows decrease in capital required under Basel II relative to the current Accord for most countries

The QIS results for G10 countries show that minimum required capital under Basel II (including the 1.06 scaling factor to credit risk-weighted assets) would generally decrease relative to the current Accord. For Group 1 banks (ie internationally active banks with Tier 1 capital in excess of €3 billion), minimum required capital under the most likely approaches to credit and operational risk would on average decrease by 6.8%. Group 2 banks show a larger reduction in minimum required capital under the IRB approaches due to the higher proportion of retail exposures for those banks.

The retail mortgage portfolio contributes the most to the reduction in minimum required capital under the standardised and IRB approaches. Since there was no explicit capital charge for operational risk under Basel I, the highest increase was due to the new capital requirements for operational risk.

In order to analyse the incentives for banks to move to the more advanced approaches, the capital requirements for banks providing data on at least two different approaches were compared. This analysis showed that, on average, capital requirements provide an incentive for banks to move to the more advanced approaches.

Joint Forum

In May 2006, the Joint Forum published two issues papers, the first one on funding liquidity risk management and the second one on regulatory and market differences.

The management of liquidity risk in financial groups is the result of a comprehensive study of liquidity risk management practices among 40 of the largest firms in the financial services industry (banks, securities and insurance firms) spanning national borders, financial sectors and currencies.

Joint Forum addresses five issues in paper on the management of liquidity in financial groups …

The review addresses five key questions: (i) how large, complex banking, securities and insurance groups manage liquidity risks across jurisdictions, sectors and subsidiary units, particularly in times of stress; (ii) the impact of regulatory and supervisory approaches on liquidity risk management practices and structures; (iii) the nature of the products and activities that give rise to significant demands for liquidity; (iv) assumptions that firms make regarding available sources of liquidity; and (v) the scale of liquidity shocks that firms are prepared to address.

… and releases paper on cross-sectoral convergence in financial industry regulation and market practice

The paper entitled *Regulatory and market differences: issues and observations* presents the findings of a review that was prompted by discussions at an industry roundtable in 2003 on differences in the regulatory approaches to risk across the banking, securities and insurance sectors. The Joint Forum determined that cross-sectoral convergence in both market practice and regulatory approaches is occurring naturally and can be expected to continue as a result of a number of trends and developments highlighted in the paper. At the same time, however, the Joint Forum recognised that cross-sectoral convergence in regulatory approaches is not desirable in every instance. There may be good reasons for sectoral differences in regulatory approaches to the same risk. The paper draws conclusions from cross-country and cross-sector comparisons in the following areas: the purpose of capital, the alignment of regulatory capital requirements with measures of risk that are calibrated using economic capital models, the acceptance of internal models for regulatory purposes, valuation approaches, the treatment of interest rate risk and operational risk, metrics dealing with risk concentrations, the regulatory approach to risk mitigation, the use of external ratings and differences in regulatory reporting requirements.