Blaise Gadanecz

+41 61 280 8417
blaise.gadanecz@bis.org

Recent initiatives by the Basel-based committees and groups

During the period under review, the Basel Committee on Banking Supervision (BCBS) published a report on international developments in banking supervision and a working paper on credit risk concentration. The Committee on the Global Financial System (CGFS) released a report on institutional investors, and the Committee on Payment and Settlement Systems (CPSS) published the final version of its report (prepared jointly with the World Bank) on general principles for international remittance services. The Financial Stability Institute (FSI) published a paper highlighting the key findings of its updated Basel II implementation survey. Table 1 provides a summary of these and other initiatives.

Basel Committee on Banking Supervision

In the fourth quarter of 2006, the Committee published a report on international developments in banking supervision, as well as a working paper on credit risk concentration. Moreover, it clarified the risk weighting for the International Finance Facility for Immunization and issued a comment on a discussion paper of the International Accounting Standards Board.

BCBS publishes 15th *Report on International Developments in Banking Supervision*

On 26 October the Committee released the 15th *Report on International Developments in Banking Supervision.* The aim of the report was to brief bank supervisors of international supervisory developments in advance of the 14th biennial International Conference of Banking Supervisors (ICBS), held in Mérida, Mexico on 4 and 5 October 2006. For the first time since the inception of this biennial series, the 15th report was made publicly available.

The report is mainly devoted to providing an overview of the work of the Basel Committee and other international groups of banking supervisors since the 13th ICBS in Madrid in September 2004. Commentary on the work of the Basel Committee over the past two years is provided in Chapter II. Chapter III presents a summary of the results of a recent Quantitative Impact Study (QIS 5), which was designed to evaluate the effects of the Basel II Framework in comparison with the current capital standards established in 1988. Chapter IV contains details of the Basel Committee’s publications and website. The work of the Financial Stability Institute (FSI) is discussed in Chapter V, while Chapter VI describes the work of the regional supervisory groups. The

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	*Report on International Developments in Banking Supervision*	• Work of the Basel Committee over the past two years • Summary of the results of QIS 5 • Details of the Basel Committee's publications and website, contact information for the international groups of supervisors • Work of the FSI and of the regional supervisory groups	October 2006
	Risk weight for International Finance Facility for Immunization (IFFIm)	• Confirmation of a 0% weighting on the IFFIm	
	Comments on the IASB's discussion paper on preliminary views on an improved conceptual framework for financial reporting	• Assessment of stewardship as an objective for financial reporting • Replacement of the concept of reliability with that of faithful representation • Definition of verifiability	November 2006
	Studies on credit risk concentration: an overview of the issues and a synopsis of the results from the Research Task Force project	• Overview of the issues and current industry practice; related policy issues • Deviations of economic capital from Pillar 1 capital charges in the IRB • Fit-for-purpose tools that can be used in the quantification of concentration risk	
FSI	*Implementation of the new capital adequacy framework in non-Basel Committee member countries*	• Update of the FSI's Basel II implementation survey, detailed statistics on implementation plans by pillars, themes and countries	October 2006
CGFS	*Institutional investors, global savings and asset allocation*	• Observed trends • Impact of regulatory and accounting changes • Policy implications	February 2007
CPSS	*Statistics on payment and settlement systems in selected countries*	• Preliminary statistics for 2005	November 2006
	General principles for international remittance services	• Payment system aspects of international remittance services, general principles for improving this market	January 2007

Source: Relevant bodies' websites (www.bis.org). Table 1

report also provides contact information for the international groups of supervisors.

Working paper highlights credit risk concentration as a major source of bank distress

On 30 November, the BCBS released a working paper entitled *Studies on credit risk concentration: an overview of the issues and a synopsis of the results from the Research Task Force project*. Historical experience shows that concentration of credit risk in asset portfolios has been one of the major causes of bank distress. This is true both for individual institutions and for banking systems at large. It is therefore important to measure the concentration risk arising in banks' credit portfolios from two sources, systematic and idiosyncratic. Systematic risk represents the effect of unexpected changes in macroeconomic and financial market conditions on the performance of borrowers. Idiosyncratic risk represents the effects of risks that are peculiar to individual firms.

RTF analytical project had three main angles:

The Concentration Risk Group of the Research Task Force of the BCBS undertook a principally analytical project with the following objectives: (i) to provide an overview of the issues and current practice in a sample of the more advanced banks as well as to highlight the main policy issues that arise in this context; (ii) to assess the extent to which "real world" deviations from the "stylised world" behind the assumptions of the IRB model can result in important deviations of economic capital from Pillar 1 capital charges in the IRB approach; and (iii) to examine and further develop fit-for-purpose tools that can be used in the quantification of concentration risk.

the current state of the art …

… the effect of departure from model assumptions …

… and the role of stress tests

The paper provides an overview of the work conducted by this group and its findings. The work of the group was divided into three workstreams. The first workstream collected information about the current "state of the art" both in terms of industry best practice and in terms of the developments in the academic literature. The second workstream focused on gauging the impact of departures from the ASRF model assumptions on economic capital and examined various methodologies that can help to bridge the gap between underlying risk and risk measured by the specific model. The workstream had two sub-themes that focused on name concentration risk (imperfect portfolio granularity) and sector concentration risk (imperfect diversification across risk factors). The third workstream dealt mostly with the ability of stress tests to detect excessive concentration (of either type) and to provide estimates of economic capital in stress scenarios.

In a *newsletter* published on 24 October, the BCBS agreed that supervisors may allow banks to apply a 0% risk weight to claims on the International Finance Facility for Immunization, similar to claims on a multilateral development bank, in accordance with paragraph 59 of the Basel II Framework.

BCBS comments on IASB discussion paper on financial reporting

The discussion paper published by the International Accounting Standards Board (IASB) in July 2006 entitled "Preliminary views on an improved conceptual framework for financial reporting: the objective of financial reporting and qualitative characteristics of decision-useful financial reporting information" has generated a lot of interest in the international supervisory community. The BCBS formulated *comments* on the IASB consultative document, with particular focus on three aspects: (i) the assessment of stewardship as an objective for financial reporting; (ii) the replacement of the concept of reliability with that of faithful representation; and (iii) the definition of verifiability.

Financial Stability Institute

On 25 October 2006, the FSI published an occasional paper on the *Implementation of the new capital adequacy framework in non-Basel Committee member countries*.

In view of the ongoing challenges and opportunities presented by the Basel II implementation process, the Financial Stability Institute decided to follow up on its original Basel II implementation survey, conducted in 2004, in order to take stock of developments since then.

FSI publishes results of its latest survey on Basel II implementation in non-BCBS member countries

Responses to the survey were received from 98 jurisdictions outside the BCBS, of which 82 intend to implement Basel II. For Pillar 1 (minimum capital requirements), 85% of the respondents intending to adopt Basel II expect to adopt the standardised approach for calculating capital requirements for credit risk. The foundation internal ratings-based (FIRB) approach and the advanced IRB approach are expected to be implemented by 67% and 55% of those adopting Basel II, respectively. With regard to operational risk under Pillar 1, the basic indicator approach is anticipated to be widely employed across regions – by 79% of those adopting Basel II – followed by the standardised approach, at 70%. About 51% of those adopting Basel II expect to adopt an advanced measurement approach for operational risk. Of the 82 jurisdictions, 61 expect to implement Pillar 2 (supervisory review process) by 2008, with an additional nine jurisdictions expecting to implement it during 2009–15. As regards Pillar 3 (market discipline), 54 jurisdictions expect to implement it by 2008 and an additional 12 jurisdictions during 2009–15.

Committee on the Global Financial System

On 28 February 2007, the CGFS released a report on *Institutional investors, global savings and asset allocation,* prepared by one of its working groups. The report identifies some current trends in the institutional investor industry, examines the impact of recent and prospective regulatory and accounting changes, and identifies some policy implications.

CGFS report highlights growing importance of institutional investors for financial systems and economies globally

Among the current trends indentified, institutional investors are becoming more important in global financial markets, with their assets under management rapidly catching up with those of the banking system. Institutional investors help to ensure deeper and better functioning markets, thus contributing to a more efficient allocation of savings, and their growth may help to counter the decline of household saving ratios associated with ageing populations. Global institutional investors have increased their exposure to emerging market economies (EMEs) in recent years. Domestic institutional investors in EMEs, although small in an absolute sense, are significant relative to the size of local markets and have considerable growth potential. The working group also analysed the importance of alternative investments and the effect of different objectives and strategies (for instance the defined benefit or defined contribution nature of the related pension schemes, or varying asset-liability management strategies) on investment behaviour.

Impact of regulatory and accounting changes affecting institutional investors

The working group was mandated to assess the effect on investment behaviour and financial markets of specific regulatory and accounting changes affecting pension funds and insurance companies. These changes were of a global nature and motivated, at least partially, by the 2000–02 equity downturn, which exposed some serious weaknesses in the regulatory frameworks affecting traditional institutional investors with long-term liabilities and offering guaranteed returns in many countries.The main effect of reforms will be to provide incentives for defined benefit pension funds and insurance companies to reduce their risk profile, either by transferring investment risk to households or by adopting investment strategies that directly incorporate liabilities into asset allocation decisions. The adoption of these techniques by institutional investors may involve shifts in asset portfolios from equities to long-term conventional and index-linked bonds, whose financial characteristics more closely resemble liabilities in terms of duration and the cash flow of obligations. In assessing influences on institutions' asset allocation decisions and on market dynamics, the working group noted that it may be difficult to disentangle the effect of regulatory and accounting changes from other factors, such as the current low level of long-term interest rates observed at a global level. However, developments in the United Kingdom, where long-term yields appear to have been affected by recent changes in institutions' asset allocation strategies, illustrate the potential importance of regulatory policy changes affecting intitutional investors.

Positive long-term effects of institutional investors for financial stability …

… with benefits in emerging markets …

… but a need to educate households

The working group also highlighted some policy implications of the growing importance of institutional investors. Recent regulatory and accounting reforms seem likely on balance to enhance the functioning and stability of the financial system and contribute to a more efficient allocation of resources. They should encourage better risk management by institutional investors, the spreading of investment risk among a larger investor base and improved transparency in corporate accounts. In the case of emerging markets, the growing demand from global institutional investors for emerging market assets is likely to be positive for these economies, and should contribute to the depth of local financial markets. The growing role of global investors in emerging markets might nevertheless alter the transmission mechanism of domestic monetary policy, especially if long-term bond yields become more dependent upon global factors. However, with the shift in the pensions sector from defined benefit to defined contribution plans, and in the insurance sector from guaranteed to unit-linked products, the household sector has become increasingly exposed to financial markets, and prospective retirement income more subject to financial market volatility.

Potential short-term distortions

While the reforms appear beneficial for financial stability in the long term, the implementation of these measures may temporarily distort prices in financial markets, eg through feedback effects with the potential to drive long-term interest rates below the levels justified by macro fundamentals. Therefore, during the transition to the new regimes, policymakers will need to take into account the risk of triggering unnecessary market volatility or distorted valuations. The increased interest in alternative investment strategies (of still limited importance in portfolios) on the part of traditional institutional investors was not perceived as a major problem for financial stability. The working group recognised the potential of regulatory policy changes to increase the transparency of the existing links and channels of risk transfer between banks and institutional investors. In addition, such changes may help to provide increased transparency on the nature and location of the risks facing financial conglomerates, reducing the opacity that has existed in the past within complex financial institutions.

Limitations and challenges

Finally, the working group encountered various limitations and challenges in using balance sheet data to study the investment behaviour of institutional investors. In particular, balance sheet data do not reflect accurately the risk exposures of institutional investors that are significant users of derivatives. If the CGFS wants to continue monitoring how pension funds and insurance companies are responding to regulatory policy changes, it needs to consider in more detail how to improve the information and/or analytical frameworks for assessing financial stability issues.

Committee on Payment and Settlement Systems

The CPSS published its final report[1] on general principles for international remittance services (prepared jointly with the World Bank) in January 2007 and updated its statistics on payments and settlement systems in CPSS countries in November 2006. The CPSS-World Bank report, published on 23 January, provides an analysis of the payment system aspects of remittances, on the basis of which it sets out general principles designed to assist countries that want to improve the market for remittance services.

CPSS-World Bank report analyses the payment system aspects of international remittances …

The flow of funds from migrant workers back to their families in their home country is an important source of income in many developing economies. The total value of these remittances has been increasing steadily over the past decade (estimated in 2005 at over $230 billion equivalent, involving some 175 million migrants). However, the related money transfers are sometimes difficult to make, particularly for low-income workers, because of the costs and logistics involved. Although in recent years a number of reports have been prepared by various organisations on the topic of international remittances, few have been devoted specifically to the practical realities of how the money is transferred.

… and sets out general principles to assist policymakers in improving this market

The report contains five general principles covering: transparency and consumer protection; payment system infrastructure; the legal and regulatory framework; market structure and competition; and governance and risk management. The report also highlights the roles of both public authorities and remittance service providers in implementing the general principles.

The *statistics on payment and settlement systems,* released on 21 November, are part of an annual publication that provides data on payments and payment systems in the CPSS countries. This preliminary release contains

1 A version of the report had been released for comment in March 2006; see "Recent initiatives by Basel-based committees and the Financial Stability Forum", *BIS Quarterly Review*, June 2006.

individual country data (partial) and cross-country comparisons for 2005 and earlier years. The CPSS intends to publish a revised version in March 2007.