Financial Stability Forum 12 April 1999
Updated

Ongoing and Recent Work Relevant to Strengthening Financial Systems

The following summary is based on reports recently provided to the Chair by the international financial institutions and groupings represented in the Forum. The summary is organised broadly around the headings of the 30th October Declaration of the G7 Ministers and Governors. Copies of the individual reports are available from the Secretariat.

I. PROMOTING TRANSPARENCY

A. IN THE PUBLIC SECTOR

Fiscal transparency (completed April 1998)
The IMF Board will receive before the Spring Meetings a revised draft manual to guide members seeking to implement the IMF Code of good practices on fiscal transparency. The revised draft incorporates comments by country authorities, international organisations and others.

Transparency in monetary and financial policies (underway)
Various working drafts of the IMF Code of Good Practices on Transparency in Monetary and Financial Policies have been submitted for consultations with central banks, financial supervisory and regulatory agencies and international organisations. The IMF Board will consider ahead of the Spring Meetings a revised draft Code taking account of these consultations.

Disclosure of foreign currency liquidity position/SDDS (completed)
Following agreement between the Committee on the Global Financial System and IMF on a template for the disclosure of the authorities' official reserves, the IMF Board adopted at end March standards of frequency, timeliness and a transition period for implementation. IMF staff and the Secretariat of the Committee on the Global Financial System (formerly the Euro-currency Standing Committee) will begin work shortly on operational guidelines for implementation.

Transparency about adherence to international standards (underway)
The IMF Board recently considered issues related to the development and monitoring of standards relevant to the functioning of financial systems, including the proposal that the Fund prepare 'transparency reports" on members' adherence to such standards. The latter draws on experience gained in pilot projects underway in co-operation with several member countries.

Transparency of IFI policies
The IMF Board will consider before the spring meetings proposals regarding the further promotion of public information notices (PINs); the public release of staff reports for surveillance and use of Fund resources; release of summary of Board discussions. The World Bank is making country assistance strategies publicly available at the request of governments.

B. IN THE PRIVATE SECTOR

Principles on Corporate Governance (underway)
A set of draft principles produced by a task force of OECD member countries are being vetted by OECD committees and has been released for public comment. The OECD, in consultation with the World Bank and other international groupings, is aiming to complete the standards for the OECD Ministerial meeting in May 1999. The OECD will produce a framework for monitoring members' compliance with the standards. The World Bank will produce by April a draft paper on principles and guidelines on corporate governance applicable to developing countries.

International accounting standards (underway)
The BCBS, IOSCO and IAIS are evaluating the elements of the proposed international accounting standards developed by the IASC. The BCBS has identified and is discussing in its Accounting Task Force the standards of possible interest for bank supervisors. IOSCO's review is limited to the core standards that the Technical Committee considers to be necessary components of a comprehensive body of accounting principles for issuers undertaking cross-border securities offerings and listings. These core standards are not intended to affect jurisdictions' more broadly applicable domestic standards. None of the groupings has indicated a time horizon for completion of their reviews.

Disclosures by financial institutions, including HLIs (underway)
A task force of IOSCO's Technical Committee and a working group of the Committee on the Global Financial System (CGFS) are considering the scope for improving disclosures of the risk profiles of financial institutions, including hedge funds. IOSCO's Task Force will consider whether direct disclosure requirements for hedge funds and HLIs are advisable and whether there are mechanisms to increase the transparency of dealing by HLIs with banks and securities firms, and expects to report in May. The CGFS's working group will submit an interim report containing disclosure recommendations to relevant authorities by April 1999 (see also the separate section on HLIs under IV below).

Policy paper on enhancing bank transparency (completed)
In September last year, the Basle Committee issued a paper on Enhancing Bank Transparency. The Paper discusses the role of public disclosure in effective market discipline and includes broad disclosure guidance. The paper serves as an umbrella paper for the Committee's efforts with respect to disclosure.

Guidance on credit risk disclosure practices (underway)
The Basle Committee has carried out a fact-finding survey on credit risk disclosure practices in banks. It has also interviewed rating agencies, equity analysts and other information users to better identify their information needs. The intention is to prepare a consultative paper containing credit risk disclosure guidance in the first half of 1999. This paper will provide guidance on best practices for public disclosure of credit risk in banking institutions. The

objective is to encourage banks to provide market participants and the public with the information they need to make meaningful assessments of a bank's credit risk profile.

Trading and derivatives disclosures by banks and securities firms (completed)
Following the release of their annual survey of disclosure practices in this area in November 1998, the Basle Committee and IOSCO's Technical Committee issued further disclosure recommendations in a consultative paper in February 1999 with the intent to finalise the guidance in the second half of 1999. The recommendations call for institutions to disclose market and credit risks estimates and their performance in managing these risks. The two committees also issued an updated framework for supervisory information about firms' trading and derivatives activities in September 1998.

Disclosure framework for securities settlement systems (completed)
The CPSS and IOSCO completed last year a framework for disclosure of risks and risk management practices in securities settlement systems. 57 institutions operating such systems have publicly posted the information called for in the framework.

C. MARKET TRANSPARENCY

Improved external debt statistics (completed)
The BIS, OECD, IMF and WB have jointly published a new series of quarterly statistics on external debt for developing and transition economies which provide more timely and comprehensive data on the various components of external debt and their maturity profile. The statistics bring together data that were previously available separately, and include data on official foreign exchange reserves. The data are posted on the web sites of the four institutions and easily downloadable by users.

Improved consolidated international banking statistics (completed/ underway)
The BIS and the CGFS are improving the coverage, quality and timeliness of the BIS consolidated creditor-based international banking statistics, including adopting a quarterly reporting frequency, reducing reporting lags, and collecting data on an "ultimate" risk basis. The BIS is also working to enlarge the reporting area by inviting major emerging market economies to report the cross-border asset and liabilities of their banking systems.

Aggregate market statistics (underway)
A working group of the CGFS is identifying gaps in aggregate information about the financial characteristics of financial and non-financial firms that could hinder the proper functioning of markets. The group is considering the desirability and feasibility of various options, including compiling aggregate position and market concentration data, improving further statistics on external debt and creditor exposures, and establishing an international credit register. An interim report will be discussed by the CGFS in June.

Aggregation of stress test outputs (exploratory)
A working group of the CGFS is also exploring ways of filling information gaps about the scale and distribution of exposures by major risk factors that hamper the functioning of traded markets under stress. Options being considered include the possible aggregation and dissemination of stress test outputs drawn from individual firms' risk management models. The group will submit a report in September 1999.

II. STRENGTHENING FINANCIAL SYSTEMS IN EMERGING MARKET ECONOMIES

Financial sector monitoring and assessment program

The World Bank and the IMF are jointly developing a framework for conducting financial sector assessments. These assessments are intended as an element of the IMF Art. IV consultation process and to provide guidance for the World Banks' financial sector development work. Individual country reviews will identify vulnerabilities, assess medium term structural weaknesses (including adoption/enforcement of international standards and best practice) and define policy responses and elements of financial sector development/assistance strategies. Assessment teams might include secondees from other official institutions and private sector consultants as appropriate.

The OECD's Economic and Development Review Committee (EDRC) and Committee on Financial Markets (CMF) also carry out regular surveillance covering both member and non-member countries. The EDRC covers the full range of domestic policies that bear on economic performance and development, including financial markets. The CMF's principal surveillance task is monitoring of global financial markets although, from time to time, it also reviews in depth the financial market structures and policies of individual countries. In addition, the OECD's Insurance Committee (IC) monitors structural changes and reform measures in insurance markets.

Implementation of Core Principles for Banking Supervision

The Basle Committee, emerging market supervisors, the IMF and the World Bank are working through various mechanisms to promote the effective implementation of the Core Principles. The Basle Committee carried out last fall a survey on the state of Core Principles implementation in individual countries. The survey was completed by 120 countries and identified areas where the Principles need elaboration or countries additional guidance. These are being addressed by the Basle Committee's Core Principles Liaison Group, in collaboration with the IMF and the WB.

To assist efforts to foster and monitor implementation of the Principles, the Basle Committee has formed a Core Principles Methodology Working Group to prepare detailed criteria for assessing the implementation of the Core Principles in individual countries. The working group comprises representatives from developed and emerging countries, the IMF and World Bank. It is expected to publish the methodology in May.

The Basle Committee is also developing guidelines and recommendations on various topics covered by the Core Principles that had not previously been addressed, and re-issued a few weeks ago an updated version of the supporting Compendium of Basle Committee documents on supervisory practices and methods.

Implementation of Core Principles for Securities Regulation

Following the adoption of the "Objectives and Principles" by IOSCO's Annual Conference in September last year, at which 97 jurisdictions and 157 member organisations committed themselves to seek changes to current legislation or regulatory arrangements that may impede adherence to the Principles, IOSCO established a Task Force to direct and oversee their implementation. The Task Force, which represents the entire spectrum of IOSCO's membership, is developing two parallel self-evaluation exercises for IOSCO members, one covering the entire set of Principles and the other discrete sections of the Principles (at first those relating to the Regulator and to the Issuer in view of their importance) for which detailed responses will be checked for quality by a peer group. The questionnaires for the self-evaluation exercises are expected to be agreed at IOSCO's Annual Conference in May.

The Task Force is also developing a proposal for the creation of a practical mechanism for providing assistance and co-operation to the international financial institutions and the OECD in relation to their use of the Principles.

Implementation of Core Principles for Insurance Supervision
Following the adoption of the Core Principles by IAIS's membership in September 1997, IAIS has organised a self-assessment survey to determine whether the principles are being complied in their jurisdictions. Forty-nine members – half of IAIS's membership – responded to the survey, most of whom reported that they were substantially in compliance with most of the principles.

IAIS is engaged in various efforts to foster implementation of the Core Principles. These include regional training programs and the development of text books and case material for insurance supervisors; drawing up a list of insurance experts who can contribute to training and consulting insurance supervisors. IAIS has also established a Task Force to prepare a methodology for monitoring the implementation of the Principles, to be carried out in close collaboration with the international organisations engaged in surveillance activities.

Development of Core Principles for payment systems
A Task Force of the CPSS, comprising G10 and emerging market economies as well as the IMF, WB and ECB, is expected to complete work on these Principles this year. The Principles are intended to provide guidance for central banks and international organisations in efforts to improve the efficiency and robustness of payments systems globally.

Orderly sequencing of capital account liberalisation
The World Bank and the IMF are both undertaking work on the orderly sequencing of capital account liberalisation and on countries' experiences with controls on capital movements, including the role and instruments of prudential controls on ST capital flows. The IMF Board recently discussed a paper on this subject. The OECD has long monitored the adherence of its members to the Codes of Liberalisation of Capital Movements and Invisible Operations, the application of which is carried out in a manner that ensures that liberalisation is properly sequenced with improvements in the functioning of markets and strengthened supervisory capacity.

Improving insolvency procedures and debtor-creditor regimes (ongoing)
The World Bank is disseminating information to governments on good practices for reform of insolvency procedures and on improving debtor-creditor regimes. The Bank is also working with the IMF, the Asian Development Bank, and the International Bar Association to assess the scope for developing principles for the design of insolvency regimes. The IMF, with contributions from the private sector and other relevant organisations, is preparing a Board paper providing an overview of key issues in bankruptcy reform. The BIS is organising workshops for central bank lawyers on issues of bank insolvency and restructuring.

Financial management standards (underway)
The IASC, IFAC and the World Bank are developing standards for financial accounting, disclosure, auditing and reporting that are appropriate for governments in developing countries.

Supervisory training programs

The international supervisory or regulatory groupings, the IFIs, and dedicated training institutions (such as the Toronto Centre and the BIS Financial Stability Institute), as well as individual central banks and supervisory authorities are expanding their training programs for bank, securities and insurance supervisory staff in emerging market economies.

III. STRENGTHENING PRUDENTIAL REGULATION AND SUPERVISON IN INDUSTRIAL COUNTRIES

A. BANKS

Revision of the Basle Capital Accord

The Basle Committee began a major effort to revise the Accord in mid-1998. The objectives in the revision are: (i) continued promotion of safety and soundness in the financial system; (ii) enhancement of competitive equality; (iii) constitution of a more comprehensive approach to addressing risks; (iv) continued focus on internationally active banks, while ensuring the Accord's underlying principles are suitable for application to banks of varying levels of complexity and sophistication. The new capital framework will consist of three pillars: a minimum capital requirement, which seeks to develop and expand on the standardised rules set forth in the 1988 Accord; the supervisory review of an institution's capital adequacy and internal assessment process; and effective use of market discipline as a lever to strengthen disclosure and encourage safe and sound banking practices.

With respect to minimum capital requirements, the Committee plans to develop and expand the standardised rules set forth in the 1988 Accord, with an aim to better align capital to underlying risk. This effort is to include expanding the set of risk-weights, introducing a new risk weighting scheme to address asset securitisation, developing a capital charge for operational risk, and refining the treatment of credit risk mitigation techniques. Within the same timeframe as its review of the standardised approach, the Committee is also seeking to develop an alternative approach for establishing minimum capital requirements at some sophisticated banks, based on the banks' internal credit ratings. This would be subject to supervisory approval, and adherence to qualitative and quantitative guidelines. Looking further ahead, the Committee will continue to analyse the potential use of credit risk models for regulatory capital requirements, as highlighted in its report, *Credit Risk Models: Current Practices and Applications,* which will be released in late April.

Principles for the management of credit risk (underway)

The Basle Committee will shortly issue a consultative paper providing guidance related to: (i) establishing an appropriate credit risk environment; (ii) operating under a sound credit granting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; (iv) ensuring adequate controls over credit risk; and (v) the role of supervisors. The paper emphasises that banks must manage the credit risk in all their activities, both in the banking book and in the trading book, and on and off the balance sheet. This paper will be issued in conjunction with other papers related to credit risk.

Collateral management, asset securitisation, and credit derivatives (underway)

The Basle Committee's Risk Management Group has prepared a draft paper on collateral management that will be issued for public comment once approved by the Committee (likely mid-year). The Committee's Capital Group, Risk Management Group and Models Task Force have been looking at the topics of asset securitisation and credit derivatives, among other credit mitigation techniques, as part of their work related to revising the Capital Accord and developing risk management techniques. This work will be reflected in future papers to be issued by the Committee.

Sound practices for loan accounting

With a view to strengthening the effectiveness of supervisory approaches, including capital requirements, and the accuracy of public financial reporting, the Basle Committee issued in October last year a consultative paper setting out sound practices with regard to the initial recognition and measurement of loans; measurement of impaired loans; the establishment of loan loss allowances; income recognition and issues relating to troubled debt restructurings as well as sound disclosure practices for loan portfolios; troubled loans; loan loss allowances and related risk management practices. Comments were due on 15 March 1999 and a final document for the Committee's approval is due in the first half of 1999.

B. SECURITIES FIRMS

Guidance on the approval of models for capitalisation of market risk

In May 1998, IOSCO's Technical Committee published a report on capital standards for internationally active securities firms which provided a qualified endorsement of the use of internal models for the calculation of market risk regulatory capital under prescribed conditions. The Technical Committee is preparing guidance to securities regulators on how to conduct the model approval process. The guidance paper is to be presented at IOSCO's Annual Conference in May 1999.

Risk management and control guidance

IOSCO's Technical Committee also adopted in May last year benchmarks by which regulators can measure the adequacy of risk management and control systems. The recommendations are based on the premise that although risk management and controls are an integral part of a well-run securities firm, they are not a substitute for adequate capital requirements.

Credit risk

IOSCO's Technical Committee is examining the current bases used by securities regulators for setting regulatory capital charges for credit risk and the advantages and disadvantages of various approaches. This includes the use of internal and external credit ratings, the recognition of hedges of credit exposures (including the use of credit derivatives), collateralisation, and the use of credit risk modelling.

Operational risk

IOSCO's Technical Committee is elaborating categories of operational risk and enquiring into current and evolving industry practice and identifying and managing these categories. The work includes identification of current regulatory approaches for proving incentives to securities firms to reduce the level of operational risk and an assessment of whether explicit capital charges for operational risk are feasible.

C. INSURANCE COMPANIES

Supervisory standards

Since adopting the IAIS Core Principles in 1997, the IAIS has issued further principles covering (i) the supervision of international insurers and insurance groups and their cross-border establishments (the "Insurance Concordat"); (ii) insurance regulation and supervision in emerging market economies; (iii) a model memorandum of understanding; (iv) licensing;

(v) on-site inspections; and (vi) derivatives. The IAIS Technical Committee is currently preparing papers on (vii) solvency; (viii) insurance accounting; (ix) asset risk management; (x) financial conglomerates; (xi) exchange of information; (xii) supervision of market conduct; (xiii) electronic commerce; (xiv) reinsurance and (xv) insurance fraud.

Standards for regulatory reporting by insurance companies (underway)
The Accounting sub-committee of IAIS, in co-operations with the IASC, is working to define a common international basis for regulatory reporting by insurance companies. The aim is to increase the consistency of supervisory financial reports and enhance system efficiency. The current aim of the IAIS Accounting sub-committee is to prepare an IAIS view on IASC standards and to make the standards developed by the IASC also an IAIS standard. The IASC process is still at an early stage. The IASC does not expect its insurance project to be finished until 2001 or 2002.

D. FINANCIAL CONGLOMERATES

Joint Forum papers on the supervision of financial conglomerates
Following detailed study of fourteen major international financial conglomerates and consultation within the industry and wider supervisory community, the Joint Forum issued in February documents addressing key supervisory issues in relation to financial conglomerates, including: (i) techniques for assessing the capital adequacy of conglomerates; (ii) facilitating the exchange of information among supervisors; (iii) co-ordination among supervisors; and (iv) testing the fitness and propriety of managers, directors and major shareholders of conglomerates. The Basle Committee and the Technical Committees of IOSCO and the IAIS have urged the members of their organisations to implement the principles set out in the papers.

E. RESPONSES TO ISSUES SURROUNDING HLIs

Basle Committee
In January, the Committee released a report analysing banks' interactions with highly leveraged institutions (HLIs). The report argues that better risk management at the counterparty level could address many of the systemic risks arising from the leverage and riskiness of HLI portfolios. To this end, the Committee issued guidance on sound practices covering: (i) policies and procedures for interactions with HLIs; (ii) information gathering, due diligence and credit analysis; (iii) measures of exposures resulting from trading and derivatives transactions with HLIs; (iv) credit limits for HLIs; (v) the linking of credit enhancement tools, including collateral and early termination provisions, to the specific characteristics of HLIs; and (vi) monitoring of credit exposures vis-à-vis HLIs, taking into account their trading activities, risk concentration, leverage and risk management processes.

The Committee also considered the desirability and feasibility of other regulatory and supervisory measures, including efforts to enhance transparency, as well as direct regulation of HLIs. The report notes that assessment of the costs, benefits, and effectiveness of direct regulation would require a comprehensive review of the potential impact on financial markets and market participants. Such measures would also require broad co-ordination with other parties.

IOSCO

A task force of the Technical Committee is expected to report on a number of regulatory issues relating to hedge funds and other HLIs in May. Its work plan includes: (i) reviewing and commenting on proposed recommendations from other international organisations; (ii) considering mechanisms to increase the transparency of dealing by HLIs with banks and securities firms; (iii) identifying better risk management and internal controls within banks and securities firms; (iv) consideration of whether direct disclosure requirements for hedge funds or HLIs are advisable and feasible; (v) co-operating closely with the BCBS in examining the applicability of its proposals on banks dealing with HLIs to the supervision of securities and derivatives firms.

CGFS

A working group has recently completed an interim report on the case and scope for strengthened public disclosures of risk profiles by financial firms, including Hedge Funds. The report argues that advances in risk management technology may justify a significant shift of the boundary between private and public information, and that enhanced disclosure practices should be adopted by all institutions engaged in trading, investment and lending activity. The report recommends the establishment of a working group comprised of representatives from a wide range of official sector organisation and regulatory bodies to develop a disclosure template and to conduct a voluntary pilot study with market participants to assess the feasibility and utility of new recommendations. A template is offered as a possible starting point for this work. The report will be submitted to relevant authorities in April 1999.

Another working group identifying gaps in aggregate information about the financial characteristics of financial and non-financial firms that could hinder the proper functioning of markets. The group is considering the desirability and feasibility of various options, including compiling aggregate position and market concentration data, improving further statistics on external debt and creditor exposures, and establishing an international credit register. An interim report will be discussed by the CGFS in June.

OECD

The OECD’s Committee on Financial Markets and representatives of the financial services industry recently discussed the implications of “Highly Leveraged Investment Strategies” for financial markets. The background paper for this discussion highlighted a number of financial policy issues that arise in this regard. The Committee will consider in October an analytical paper on HLIs that would serve as a framework for developing a better understanding of the practices of such institutions, and on how leverage might affect the dynamics of financial markets.

G7 Financial Experts

In the fall of last year, the G7 financial experts agreed to gather for each of their countries brief descriptions the existing regulatory reporting requirements applicable to hedge funds.

STRENGTHENING MARKET FUNCTIONING AND INFRASTRUCTURE

Reduction of foreign exchange settlement risk (ongoing)
The CPSS continues to monitor and encourage private sector developments to reduce FX settlement risk, including the establishment of the CLS Bank. Dialogue with market participants is expected to continue into next year. The CPSS is also co-operating with the Basle Committee in developing guidance for banking supervisors in this area.

Securities lending (underway)
A joint IOSCO/CPSS working group on Securities Lending is finalising a report that analyses the implications of securities lending and similar transactions for securities regulators and central banks, and in particular their impact on securities clearing and settlement systems. The report will be presented to the CPSS and IOSCO's Technical Committee at their respective meetings in May.

Repo markets (completed)
A working group of the CGFS has completed a report examining the structure of functioning of repo market in several industrial countries and in the euro area. The report considers the potential systemic implications of repo markets, and outlines preconditions for the proper development of these markets.

Determinants of market liquidity (underway)
A study group of the CGFS is finalising a report examining the determinants of market liquidity from the theoretical and empirical perspective. The report also reviews the structure and functioning of government securities markets in several industrial countries and draws a preliminary set of conclusions regarding the preconditions for the development of liquid markets.

IV. THE YEAR 2000 PROBLEM

Since 1997, the BCBS, IOSCO, IAIS and CPSS have co-ordinated their activities with regard to achieving Y2K industry readiness through the Joint Year 2000 Council. The supervisory groupings have recently published reports setting out steps for contingency and continuity planning with a view to limiting the impact on other institutions and wider markets from Y2K problems. The papers focus on four common concerns that regulators and supervisors should address in their contingency and continuity planning: (i) ascertaining industry readiness and identifying weaknesses that may result in problems; (ii) managing the risk of regulated entity failures; (iii) preparing regulatory entities for dealing with Y2K problems; and (iv) responding to actual Y2K related disruptions. An overview paper prepared by the Council addresses a number of issues critical to the smooth functioning of the financial system, including the maintenance of appropriate liquidity at the wholesale and retail levels, and the need for co-ordinating domestic and international contingency strategies. The Council will consider in the coming months cross-border contingency planning, public communication strategies, and even management procedures for the actual "day zero" transition to 2000. The Council is also co-operating closely with various private sector groupings.

V. CRISIS MANAGEMENT

Involvement of the private sector
The IMF Board has considered a range of proposals advanced to better involve the private sector, both in preventative fashion and as crises emerge or deepen.

Contingent credit lines
The IMF Board has further considered the proposal that the Fund establishes such arrangements to help guard against contagion, drawing in part of recent informal discussions with G7 Executive Directors.

IMF policy on lending into arrears
The IMF Board will give further consideration to the circumstances and conditions under which it would be prepared to lend into arrears to private sector entities, an extension of policy that has already been agreed.

Safety nets
A working group of the CGFS is examining the implications of structural changes in the financial environment for the role of central banks as providers of emergency liquidity support.