Basel Committee meets with wider group of supervisors; issues documents on Basel II and the use of the fair value option

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As part of its active dialogue with supervisors from around the world, the Basel Committee on Banking Supervision met today in an expanded session with the Core Principles Liaison Group (CPLG), the Committee's working group that includes banking supervisors from sixteen non-Committee member countries.[1] The CPLG was originally established to monitor the implementation of the core principles for effective banking supervision, but has since evolved into a forum for more general debate and liaison with the Basel Committee. The meeting, which was hosted by the National Bank of Poland in Krakow, provided an opportunity for supervisors to exchange views on such issues as current efforts to update the core principles for effective banking supervision, implementation of the revised capital framework for banking organisations (Basel II, or the Revised Framework), corporate governance and issues related to accounting and auditing.

"In light of the challenges of supervising internationally active banking organisations, it is vitally important that the Basel Committee continue its dialogue with the wider supervisory community," said Mr Jaime Caruana, Chairman of the Basel Committee and Governor of the Bank of Spain. "This meeting represents a further step in the process of involving that wider community in the work of the Committee, and the insights gained today will guide us in the coming period. We will continue this important process of dialogue through future meetings with the CPLG and regional groups of banking supervisors, the biennial International Conference of Banking Supervisors, and other formal and informal mechanisms."

"We are very pleased to have hosted a successful meeting between the Core Principles Liaison Group and the Basel Committee, and I welcome the opportunity to exchange views among my colleagues in the banking supervisory community," stated Mr Leszek Balcerowicz, President of the National Bank of Poland. "The discussions today were very fruitful, and I hope that this meeting will be a model for future work."

Today the Basel Committee also agreed to issue several documents. Regarding Basel II, the Committee issued guidance on the estimation of loss given default (LGD) during economic downturn conditions.

In addition, the Committee reviewed with satisfaction the results of its joint work with the International Organization of Securities Commissions (IOSCO) on the treatment of certain trading-related exposures and double default effects under Basel II. A separate press release and document in this regard will be forthcoming shortly.

These documents represent the completion of the near-term work program that the Committee established when it published the Revised Framework. The Committee will now concentrate its efforts on Basel II implementation and other elements of effective banking supervision.

Also related to Basel II, the Committee agreed to issue consultative materials on the fifth quantitative impact study (QIS 5).

In addition, the Committee issued a consultative paper on supervisory guidance for the use by banking organisations of the fair value option amendment issued by the IASB on 16 June 2005.

Basel II related publications

Loss given default in economic downturns

Paragraph 468 of the Revised Framework states that a bank "must estimate an LGD for each facility that aims to reflect economic downturn conditions where necessary to capture the relevant risks." The Committee has released a paper providing guidance on the application of this requirement. This paper provides principles that banks are expected to fulfil in order to become eligible to use own-estimates of LGDs within the internal ratings-based approach of Basel II.

The potential for realised losses to be higher than average during times of high default rates may be a material source of unexpected credit losses for some exposures. The Committee has decided that elaborating the requirements based on a sufficiently flexible principles-based approach seems most appropriate at this time. The Committee will continue to monitor industry practice and encourage the development of appropriate approaches to this issue.

QIS 5 workbook and instructions

Consistent with the schedule set out in its newsletter in March 2005, the Committee today issued a draft of the QIS 5 workbook and accompanying instructions. Comments from banks intending to participate in QIS 5 are welcomed by 5 August 2005.

The Committee intends to publish the final version of the QIS 5 package in September 2005, in time for the data collection exercise to be carried out between October and December 2005.

Consultative paper on supervisory guidance for the use of the fair value option

Furthermore, the Committee has issued a consultative document that discusses supervisory guidance on banks' use of the IAS 39 fair value option.

Two key areas of supervisory guidance are addressed: first, what constitutes a set of sound risk management and control processes around use of the option; and, second, how a bank's use of the option might affect supervisory assessments of a bank's risk management systems and regulatory capital. In addition, the guidance suggests additional information that supervisors might collect to help them better understand how banks are using the fair value option and how this use impacts the supervisory assessment of banks' financial condition. This proposal does not impose additional accounting or disclosure requirements beyond those set out in the IAS 39 fair value option amendment that was issued in June 2005.

Under the approach set forth in the consultative document, for those banks capable of fully meeting the supervisory expectations set out in this paper, no adjustments to regulatory capital would be required as a consequence of their use of the fair value option. One exception to this general approach is the Committee's view, published in June 2004, that gains and losses arising from changes in a bank's own credit risk associated with its liabilities should not be included in a bank's regulatory capital. For banks that do not meet the supervisory expectations set forth in this consultative paper, a range of possible supervisory responses is discussed, including possible supervisory actions with respect to regulatory capital.

This paper will be open for comment until 31 October 2005.

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[1] Non-Basel Committee member countries represented on the CPLG are Argentina, Australia, Brazil, Chile, China, Czech Republic, Hong Kong SAR, India, Korea, Mexico, Poland, Russia, Saudi Arabia, Singapore, South Africa and the West African Monetary Union. The International Monetary Fund and World Bank are also CPLG members.