

# The Basel Process and Financial Stability\*

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## Abstract

The Basel Process is a key element of the global financial system and as such plays an important role in co-ordinating the multilateral efforts of various committees, uniquely geared towards fostering and maintaining financial stability.

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“The objects of the Bank are: to promote the co-operation of central banks and to provide additional facilities for international financial operations [...]”

*Article 3, BIS Statutes (20 January 1930)*

## I Introduction

In the almost 75 years since it was first drafted, Article 3 of the BIS Statutes has lost none of its relevance for the process of fostering a stable global financial system. Strengthening both monetary and financial stability is the traditional remit of central banks and other monetary agencies, but achieving these twin objectives may not be possible without the close co-operation of other regulatory and supervisory bodies.

In addition, the various components and players of the global financial system - namely the financial markets themselves, institutions and the associated infrastructure - may not all be subject to the same sources of concern and threats, thus requiring different policy approaches and measures in order to achieve the stability of the financial system as a whole. Because the stability of the financial system depends so critically on the institutions, structures and governance arrangements that comprise it, continued policy coordination and cooperation is paramount. The Basel Process plays a key role in strengthening the stability and resilience of the global financial system.

## II Promoting monetary and financial stability

Promoting both monetary and fiscal stability are key goals for the authorities, but while there is broad agreement on the definition of the former, this much

less the case for the latter.

## A Definitions matter

The consensus with regards to the definition of monetary stability has emerged over the last ten years and permits various notions ranging from stability of the (anticipated) value of money, to price level stability or even low levels of inflation. Indeed, there is also broad agreement that it is a vital ingredient for sustainable economic growth, has got a unique institutional responsibility (i.e. the central bank) and that the authorities need to be engaged in continuous efforts to achieve it. The story for financial stability is somewhat different as there is a much broader spectrum of definitions; consensus only seems to exist in as far as financial stability is deemed a “good thing” and is mostly noticed when it is absent.<sup>1</sup>

Broadly speaking, we can distinguish between a systems approach – primarily linking financial stability to a well-functioning financial system<sup>2</sup> – on the one hand, and a more narrow definition relating the term to the (excess) volatility of an observable financial variable such as asset price volatility or interest rate smoothness. The debate around finding a suitable definition is more than a semantic one, particularly since such a definition then predetermines the role of monetary policy in contributing to financial stability.

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<sup>1</sup>One of the earliest definitions of financial stability is given by Bagehot (1873): “[It is . . .] not a situation when the Bank of England is the only institution in which people have confidence. More recently, during the 1997 Jackson Hole conference dedicated to “Maintaining Financial Stability in a Global Economy”, Crockett (1997) introduces the distinction between two types of financial instability: that of institutions and that of markets.

<sup>2</sup>Mishkin (1992) offers a systems-based definition, describing a stable financial system as one which ensures “[. . .] without major disruptions an efficient allocation of savings to investment decisions”.

## B A trade-off between monetary and financial stability?

In the sense of Tinbergen (1956), if the CB has only one policy instrument, namely monetary policy, it can only achieve one independent goal, which is price stability. By delegating the broader objective of financial stability to a financial regulatory authority, time inconsistency complications of a direct trade-off between the two goals can be avoided. In turn, this then raises the question for policy makers of identifying suitable trade-offs between monetary and financial stability.<sup>3</sup>

The conventional view is highly skeptical concerning existence of trade-off, since monetary instability – i.e inflation distorting perceptions about future return possibilities – is regarded as the main threat to financial stability. According to this view price stability is almost a *sufficient condition* for financial stability. In this sense, central banks should not focus on gauging the effects of asset price inflation on core inflation, but should rather place their focus on capital requirements that increase with growth of credit collateralised by inflated assets<sup>4</sup>

More recently as inflation rates have reached historic lows in most industrialised economies, a new school of thought has emerged which suggests that low and stable inflation can make financial system even more vulnerable due to the threat of asset price bubbles and the associated “irrational exuberance”.<sup>5</sup>

In an attempt to reconcile these conflicting views, Issing (2003) concludes that the strict systems-based definition of financial stability excludes any trade-

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<sup>3</sup>If financial stability is indeed defined as interest rate smoothness, a trade-off with price stability immediately follows from Poole’s (1970) result, whereby in the face of an aggregate demand shock the monetary authorities need to choose the degree to which they want to stabilise interest rates or output and inflation.

<sup>4</sup>See also Schwartz (1995; 2002) for one of the most vociferous proponents of this school of thought.

<sup>5</sup>Borio et al. (2003) provide an overview of this so-called new environment hypothesis.

off between monetary and financial stability, by definition. The key to solving this apparent contradiction lies in shifting the focus on to the *policy horizon*: In this context, a short-term conflict between monetary and financial stability may indeed be possible, as long as it is optimal for the authorities to deviate from desired rate of inflation to maintain price stability over medium run. With the clear definition of an appropriate horizon to which policy objective should apply, the conflict disappears. In a more radical interpretation of the issue, Laidler (2004) argues strongly that the authorities should stick to basic task of targeting inflation while holding lender of last resort (LORL) powers in reserve, and not be tempted by any form of trade-off simply for the sake of achieving financial stability.

The institutional responsibilities for financial stability are traditionally shared across different institutions, namely finance ministries, the central bank and regulators. While clearly defined accountability of each of the institutions involved is a sine-qua-non, the actual goal of financial stability can only be bought about by an effective coordination of these efforts. This is the role of the so-called Basel Process.

### III The Basel Process

As a direct result of the globalization of domestic financial markets, central banks and regulatory authorities have recognised the growing need for a central vehicle for coordinating their efforts. With their various regulatory and supervisory initiatives and by providing the institutional building blocks, the Basel-based committees form the natural home for such a global coordination exercise. Collectively, this interaction of the committees and their working

groups is often referred to as the *Basel Process*. As such, it refers to a global framework of regulatory and supervisory harmonization of processes and standards. Despite its global focus, one of the unique features of the process is its ability to incorporate regional elements without necessitating separate regional channels for cooperation.<sup>6</sup>

One of the most prominent components of the Basel Process is the new capital adequacy framework, commonly referred to as *Basel II* (2004), which after almost four years of intense consultation was endorsed by central bank governors and the heads of bank supervisory authorities of the G10 in June 2004. More generally, the Basel Process serves as the infrastructure to facilitate the creation of such standards as the twenty-five *Core Principles for Effective Banking Supervision* (1997) or, as mentioned, *Basel II*.

## A Components of the Basel Process

There are four main Basel committees that are at the very centre of the Basel Process. The *Basel Committee on Banking Supervision* (BCBS), established by the G10 central banks in 1974, deals with the activities of commercial banks – it this committee (including its roughly twenty-five technical working groups) which is responsible for the new capital adequacy framework.

The Markets Committee<sup>7</sup> together with the *Committee on the Global Financial System* (CGFS), established in 1963 and 1971 respectively, broadly cover issues related to the functioning of foreign exchange and related financial markets. Whilst both committees focus on recent developments, possible

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<sup>6</sup>For a comprehensive treatment of the various aspects of regional harmonisation, particularly in Asia, and the Basel Process, see Yoshikuni (2002).

<sup>7</sup>Unlike the CGFS, the Markets Committee does not have a formal policy mandate from the G10 governors and mainly serves as a forum for an open and informal exchanges of views amongst senior officials responsible for market operations in the G10 central banks.

future trends, and considerations of the short-run implications of particular current events, discussions in the Markets Committee are informal and not released to the public whereas those in the CGFS are conducted with a view to formulate appropriate policy recommendations for central banks. The topics monitored by the CGFS are also often referred to as ‘macroprudential issues’.<sup>8</sup>

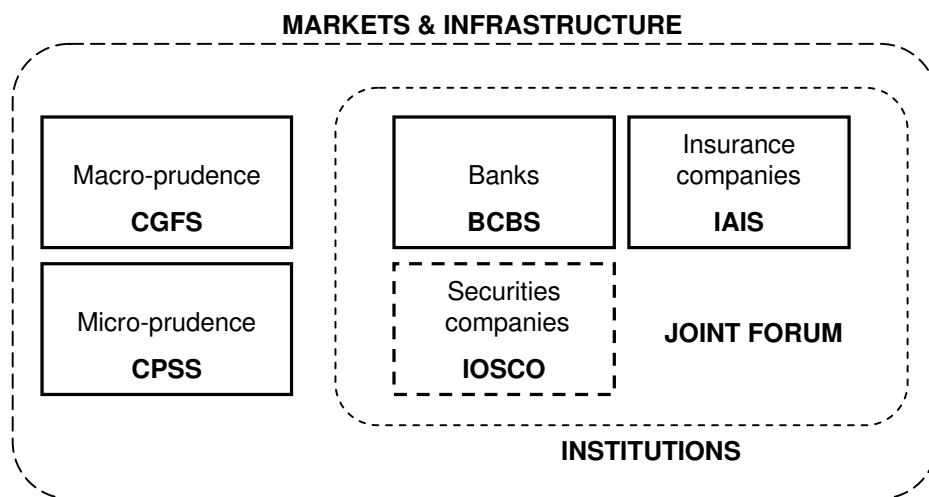
The *Committee on Payment and Settlement Systems* (CPSS), established in 1990, focuses on market infrastructure issues and therefore monitors and analyses developments in domestic and cross-border payment, settlement and clearing systems. The *International Association of Insurance Supervisors* (IAIS), established in 1994, deals with various aspect of insurance companies.

Given the complexity and linkages between the various relevant topics that form the area of competence of the Basel-based committees, successful international cooperation is only possible as long as there exists a clear division of labour between the individual committees and their secretariats. Regular meetings at either the committee or working group level form the main mechanism that drives the process. However, a common criticism levered at meeting-based efforts driven by other international bodies is that such processes are overly bureaucratic, cumbersome and - not at least because they are heavily influenced by opinions and beliefs of the organizing body - they lack a free and open exchange of views and discussions. The informal nature of the Basel Process avoids many of these pitfalls, despite a considerable amount of ‘behind the scenes activities’.<sup>9</sup> In addition, with many of the key issues pertaining to the stability of the global financial system becoming increasingly integrated

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<sup>8</sup>See Borio et al. (2003) for a detailed description of this concept and how it relates to other aspects of regulatory and supervisory arrangements.

<sup>9</sup>E.g. the multi-year effort in the context of the review of the 1988 Accord on capital adequacy involved more than 40 working groups, including many ad-hoc and temporary ones to be coordinated under the umbrella of the BCBS.



**Figure 1: The Basel Process**

BCBS: Basel Committee on Banking Supervision; CGFS: Committee on the Global Financial System; CPSS: Committee on Payment and Settlement Systems; IAIS: International Association of Insurance Supervisors; IOSCO: International Organisation of Securities Commissions

across markets, participants and borders, coordination of activities amongst the committees is also of paramount importance. Yoshikuni (2002) summarises the key function of the Basel Process as one of

“[... providing] the international financial community with the opportunity to explore good governance in various regulatory and supervisory issues in forums that allow a frank exchange of views with the support of highly sophisticated analysis.” (p.5)

Figure 1 gives a schematic overview of the specialised ‘division of labour’ between the various committees involved in the Basel Process.



## B Evolution and Increasing Co-operation

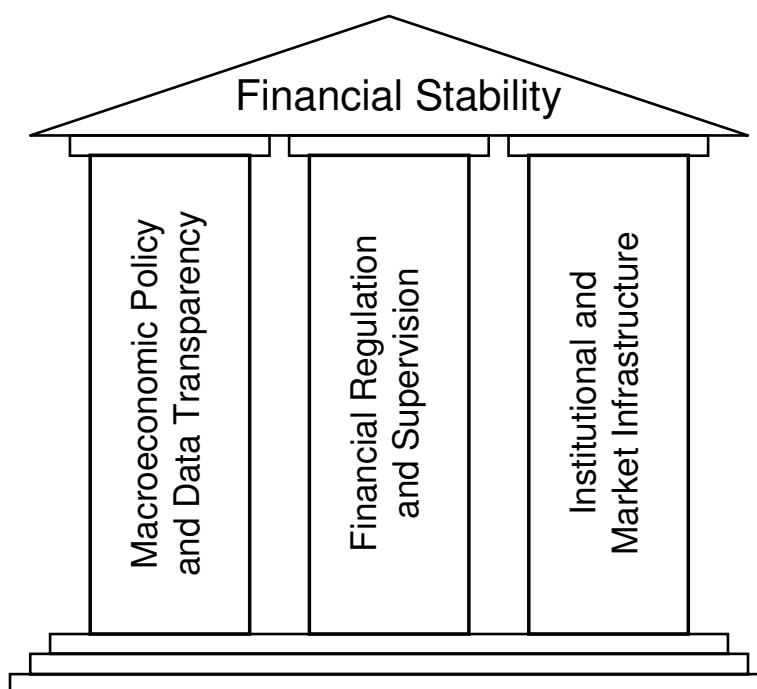
The influence of market participants has rendered the Basel Process more transparent and market oriented. The inclusion of a new element into the process is probably best illustrated in the context of Basel II, particularly, the decision to allow banks to use their internal models to assess risks. Furthermore, financial innovations evolving at increasing speed and stronger global linkages between markets have called for the closer cooperation of the various Basel-based committees at different levels and intensities.

As the intensive deregulation, liberalisation and globalisation of the 1990s led to an increasing erosion of the dividing lines between banks, securities companies and insurance companies, closer cooperation between the regulatory and supervisory bodies dealing with the specific segments of the market became a pressing priority. As a response to this challenge, the *International Organisation of Securities Commissions* (IOSCO) was involved more actively in the Basel Process with the aim of staying in closer contact with the BCBS and IAIS. In 1996, a Joint Forum of the three committees was established.

The globalisation of financial markets also called for closer cooperation between the elements of the Basel Process responsible for the overall functioning and stability of the financial system. This has led to a strengthening of ties of the CGFS and the CPSS with the other committees, respectively monitoring macro and micro aspects of the infrastructure of the international financial system. In addition, the BIS and the BCBS jointly established the *Financial Stability Institute* (FSI) to promote cooperation amongst supervisors, primarily through sharing experiences in workshops and seminars.

As the convergence of global best practices continued, the need for more coordination and cooperation also became more apparent at the level of various

other international standard setting bodies and the institutions entrusted with monitoring these standards, primarily the IMF and the World Bank. In 1999, the establishment of a more comprehensive framework for coordinating these efforts was placed under the umbrella of the *Financial Stability Forum* (FSF), which hosts its secretariat at the BIS, but is operationally independent from the BIS and only reports to its members.



**Figure 2: The Pillars of Sound Financial Systems**

The FSF is the main international body orchestrating financial stability efforts, bringing together national financial authorities, international finan-

cial institutions, international regulatory and supervisory groupings as well as committees of central bank experts. It seeks to co-ordinate the efforts of these various bodies in order to promote international financial stability, improve the functioning of markets, and reduce systemic risk. In an attempt to improve the architectural blue-print for the global international financial system, the FSF designated twelve key standard areas as key for sound financial systems and deserving of priority implementation, depending on individual countries' circumstances.

As is shown in figure 2, these areas can loosely be grouped into three categories, which in turn form the pillars which form the basis for sound financial systems.

- *Macroeconomic policy and data transparency* forms the first pillar of sound financial systems; defining standards for transparency with regards to monetary and financial policy, fiscal policy and data dissemination, this is almost exclusively the responsibility of the IMF.<sup>10</sup>
- The second element focuses on *financial regulation and supervision*, in particular the principles and objectives that fall under the auspices of the Joint Forum with regards to banking and insurance supervision and securities regulation.
- The third pillar covers all issues related to *institutional and market infrastructure*, stretching from corporate governance, international accounting standards and auditing to payments and settlements. Both the BCBS (through the aspect of market discipline under Basel II) and, more directly, the CPSS through its Core Principles form Basel Process-related

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<sup>10</sup>See the IMF's Code of Good Practices on Monetary and Financial Policies, Code of Good Practices in Fiscal Transparency and the Data Dissemination System (GDPS, SDPS).

elements of this last aspect of global financial stability.

## C Current Sources of Concern or Threats to Financial Stability

Similar to its monetary equivalent, achieving financial stability is not a one-off effort but rather a continuous quest by the various bodies involved in the process. As such, identifying potential threats is a key ingredient for a continuous strengthening of the stability of both national and global financial systems, the boundaries of which have become increasingly blurred due to increasing inter-market linkages. Put differently, the separation between national and global aspects of financial stability look increasingly artificial, not at least because of the incessant threat of contagion. At present, there are a number of issues on the radar screens of different bodies (listed in no particular order of significance or preference):

- *Resilience of financial markets and institutions:* As historically low global growth rates lead to sharp corrections in market valuations, the balance sheets of many financial institutions came under immense strain (skyrocketing default rates, collapsing equity markets and widening credit spreads). Unlike in previous comparable periods, the financial systems seem to have endured the recent slowdown remarkably well. Whilst there is ample evidence that markets currently perceive the system as stable and improving, there may be impending systemic risks that have built up in the process. Could there be a threat to future financial resilience, if the macro environment does not improve further?
- *Excess global liquidity:* Accommodative monetary policy in many indus-

trial economies has supported a revival of the global economy after several major adverse shocks. However, the associated strong growth in liquidity has raised some concern, including accelerated inflation, financial imbalances and spillovers from the G3 to other smaller economies.

- *Concentration risk*: [to be expanded]
- *Role of the central bank as LOLR vs. risks emanating from non-bank institutions* [to be expanded]

## IV Outlook

The Basel Process plays a key role with regards to this aspect of promoting financial stability in that the various committees provide a unique platform or forum for discussing and analysing current sources of concern or threats to stability. All of which - in isolation or combination with each other, both short term and longer term - need diligent monitoring and a close consideration of the appropriate steps in order to ensure further progress in the respective fields.

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