Basle Committee
on
Banking Supervision

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Prudential supervision of banks' derivatives activities

Introduction and overview

1. Much of the recent work of the Basle Committee on Banking Supervision[1] has focused on the risks from financial activities which fall outside banks' traditional business of taking deposits and making loans. In this context, the derivatives markets - e.g. markets in futures, swaps and options - have been a particular focus of attention. An enormous amount of research and analysis have been conducted by a range of public, private and academic bodies since the well-publicised warning by the Committee's then Chairman, Mr. Corrigan, in January 1992 that senior management needed to pay greater attention to the risks arising from derivatives activities.

2. Nearly all the Committee's publications released within the past decade have taken account of banks' involvement in derivatives activities. However, in part because it subscribes to the view that derivatives generally involve risks to which banks have long been exposed, the Committee has not until this year released any publications directed solely to derivatives risks. The Governors of the central banks of the Group of Ten countries now believe it would be useful if the Committee were to publish the present report, primarily destined for other supervisors, describing the manner in which its own past and ongoing work takes account of derivatives risks in their various forms.

3. Although derivatives bring undeniable benefits to users in the financial community, derivatives activities can affect the overall risk profile of an institution, and could also significantly impair overall financial system stability if banks do not conduct these activities in a safe and sound manner. In this context, supervisors focus on how individual institutions manage their risks, thereby promoting the stability of the financial system as a whole. This report confines itself to the measures which supervisors can take at the micro-prudential level to protect the safety and soundness of individual banks and does not seek in

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[1] The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central-bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basle, where its permanent Secretariat is based.

any way to assess the wider systemic or macro-economic risks which the derivatives markets may generate.

4. Derivative products pose the same risks (albeit often in more complex forms) as those associated with other financial instruments, e.g. credit risk, market risk, funding risk, market liquidity risk, legal risk and operations risk. These risks, as well as systemic risk, have been analysed in considerable depth by various authorities as well as by industry bodies.

5. Supervisors have traditionally paid closest attention to credit risk, which has been and, according to recent experience, remains the risk most likely to cause a bank to fail. The Committee has thus taken pains to see that derivatives are included in all aspects of credit risk assessment, such as risk-based capital standards, provisioning requirements and large exposure rules. Banks are also exposed to market or price risk through their derivatives positions, whether intended to hedge or to take a view on rates, prices or indexes. Here again, techniques developed to measure these risks have paid close attention to the positions taken in the derivative markets. Another significant area of concern is operations risk because the sheer complexity of the products makes it all the more difficult for managers to monitor their positions.

6. Bank supervisors can directly affect the behaviour of banks, but not necessarily that of non-bank participants. Regulations applicable to derivative activities, to the extent that they were to apply to banks alone, might upset competitive equilibrium and lead to a reduction in market liquidity. To avoid these risks, it is important that similar rules apply to the derivatives activities of both bank and non-bank financial institutions. The Basle Committee has thus worked hard to develop a close relationship with other financial regulators, particularly with securities regulators, and in its work on derivatives it will continue to seek cooperation with securities and other financial regulators.

7. The report considers risks arising from derivative activities, defined as financial contracts whose value depends on a reference rate or the value of an underlying asset or index. Their prime purpose is to transfer risks associated with fluctuations in factors such as interest rates, exchange rates, and the prices of equities and commodities more efficiently. Derivatives comprise, inter alia, futures and forwards, swaps, options and instruments with similar characteristics. Derivatives are a sub-set of off-balance-sheet contingencies and commitments. The traditional off-balance-sheet items not treated as derivatives in this document include credit substitutes, such as acceptances, guarantees, letters of credit, forward asset purchases and general commitments to lend (including standby facilities and credit lines). The credit risk arising from both classes of off-balance-sheet items were addressed in the 1988 Capital Accord.

8. This report is structured as follows:

- the first section describes the *past work* of the Basle Committee which has had an effect on banks' derivative activities;

- the second section records a number of different *projects currently in train*, all of which address more or less directly the risk of derivatives activities;
- the third section addresses issues relating to banks' *management and control* of derivatives risk;
- the fourth section briefly reviews concerns about *payments and settlement issues*;
- the fifth section briefly discusses *reporting, accounting and disclosure issues*.

I. Previous initiatives by the Basle Committee affecting derivatives

(a) Early concerns

1. The Basle Committee first discussed derivatives in a systematic manner exactly ten years ago in late 1984, when it conducted a survey on the extent to which different types of off-balance-sheet exposures were subject to supervisory reporting or included within capital adequacy tests. It concluded that reporting was very uneven and in many centres no data were being systematically collected. The Committee agreed, therefore, to investigate further and to examine the extent to which off-balance-sheet risks should be taken into account in capital adequacy regimes.

2. In July 1985 the Committee circulated a short statement to non-G-10 supervisory authorities expressing concern about the implications for supervisory systems of the rapid growth in off-balance-sheet risk and warning of the need for banks to have adequate control systems. The G-10 Governors issued similar warnings in their own centres and shortly afterwards the Bank for International Settlements published an in-depth analysis of innovative products entitled "*Recent innovations in international banking*", the so-called Cross Report prepared by a study group of the Euro-currency Standing Committee of G-10 central banks.

3. Also in 1985, the Basle Committee established a working party to examine the risks for banks associated with various types of off-balance-sheet transactions and to recommend how such risks should be reflected in capital adequacy measures. The results of the study form the basis for the treatment of off-balance-sheet and derivatives risks in the 1988 Capital Accord (see (b) below). In view of the importance of the analysis, and the relatively new concepts which it elaborated, the study was published in March 1986 in a document entitled *The management of banks' off-balance-sheet exposures: a supervisory perspective*. The first part of the study addressed liquidity and market risks arising from off-balance-sheet activities, such as funding risk, interest rate risk and foreign exchange risk. A special section was devoted to the risks in options trading. The second part analysed the credit risks inherent in different off-balance-sheet activities, with a special section devoted to the credit risk arising from positions in derivatives. The third part considered other risks, such as large exposures, settlement risk and country risk, while the final part was devoted to banks' management and control of risks and the supervisor's role in monitoring them.

4. The working group set up to prepare this report has continued to meet at regular intervals ever since, conducting a wide range of studies relating to derivatives risk and forming an effective contact point for the member institutions to learn about new developments in other centres. Although the group's work has not focused solely on derivatives, since its mandate covers all off-balance-sheet risks, its main focus of attention has been innovations in the derivatives field.

(b) The 1988 Capital Accord

5. The minimum capital standards for banks approved in July 1988 primarily address credit risk, which was and remains the principal cause of significant problems for banks. One of the reasons for adopting a risk-based capital framework, rather than a simple gearing method, was to incorporate off-balance-sheet risks. At the time, most off-balance-sheet risks were in the form of credit commitments and contingencies. So-called "credit conversion factors" were used to translate contingent liabilities into credit equivalent amounts. Derivatives, however, need a wholly different approach since the holders are exposed not so much to a credit risk on the full face value of the underlying instrument but to the cost of replacing the contract if the counterpart defaults.

6. The measurement of risk in this area is the most complex section in the Capital Accord and considerable statistical research was conducted in order to define an appropriate treatment. A choice between two methods is permitted, subject to the approval of the national supervisor. In the approach more commonly used, the so-called "current exposure" method, the credit risk in derivatives is assessed by calculating the current replacement cost (which equals the "mark-to-market" value, if positive, and zero otherwise) and by adding a factor designed to reflect potential exposure during the remaining life of the contract (the so-called "add-on"). The add-ons are based on the notional principal of each contract and vary depending on two factors: first, foreign exchange contracts have higher weights than interest rate contracts, because of the higher volatility associated with certain currency pairs and also because foreign currency swaps normally involve an exchange of principal at maturity; second, contracts with a residual term exceeding one year bear higher weights than those under one year.

7. The alternative method of measuring the credit risk in derivatives, the "original exposure" method, does not take the current value of the contract into account, but is expressed solely as a fraction of notional principal, the fraction being determined according to contract type and maturity. Here, too, foreign exchange contracts attract higher weights than interest rate contracts, and there is a higher conversion factor for each extra year of maturity. Because this is a less accurate measure of risk, which does not incorporate the mark-to-market values of banks' positions, the conversion factors are intended to be somewhat more cautious than in the current exposure method.

8. In assessing the credit risk on derivatives, the Capital Accord makes a distinction between exchange-traded and OTC products. On most exchanges, outstanding credit risk is eliminated at the end of each day by the transfer of cash variation margin from the debtor to the creditor. The Accord therefore exempts contracts traded on exchanges subject to daily margining requirements.

9. Three other features of the treatment of derivatives in the Capital Accord are worthy of remark. One is that in measuring their exposures, banks may take advantage of the concessions in respect of eligible guarantees and collateral recognised in the Accord generally. Secondly, because of the perceived superior credit quality of counterparties in the derivatives markets, the private sector credit risk weight is capped at 50%, not 100% as in the remainder of the Capital Accord. However, the Committee undertook to keep a close eye on the credit quality of participants in these markets and reserves the right to raise the weights if average credit quality deteriorates or if loss experience increases.

10. The third feature of the treatment of derivatives in the Capital Accord is the recognition of bilateral netting (allowing banks to weight net rather than gross claims with the same counterparties). At the time the agreement was concluded, close-out netting[2] was not considered to have been sufficiently tested in the courts to be admitted, nor did the Committee regard as satisfactory the legal opinions concerning the robustness of close-out netting, i.e. its ability to prevent liquidators from "cherry-picking". The Capital Accord therefore restricted netting to bilateral netting by novation[3]. It did, however, encourage banks to continue to employ contracts which might protect them in the event of default and said it would continue its work to assess the acceptability of other forms of netting (see section II (b) below).

(c) Risks in computer and telecommunication systems

11. In July 1989, the Basle Committee circulated a paper to non-G-10 banking supervisors for circulation to their banks on the risk of errors or frauds in the electronic data processing environment. While this paper addresses the risks of payment and settlement interruptions, viruses, security violations and the like, rather than derivatives activities as such, the need to maintain effectiveness of systems is clearly vital in managing derivatives risk. Many of the best practices laid down in the paper would therefore apply automatically to the prudent management of derivatives operations.

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2 Close-out netting refers to an arrangement to settle all contracted but not yet due liabilities to and claims on a counterparty by one single payment, immediately upon the occurrence of one of a list of defined events, e.g. bankruptcy filing.

3 Netting by novation refers to the replacement of existing contracts between two parties for delivery of a specified currency on the same date by one single contract for that date, such that the original contracts are satisfied and discharged.

(d) Concentration risk

12. The principle of risk diversification is at the core of sound banking practice. In January 1991, the Basle Committee issued a guidance paper for supervisors suggesting a framework for measuring and controlling large credit exposures. The paper recommended a method of measuring this risk and suggested limiting counterparty exposures to 25% of the lending bank's capital, a standard that has been widely adopted both within and outside the G-10. One of the key issues addressed was how to define an exposure to a single borrower. The paper gave guidance not only in respect of standard credit techniques, but also on a wide range of off-balance-sheet commitments, including derivatives. It suggested that although banks may use as a proxy the current or original exposure measure set down in the Capital Accord, this might be an underestimate of the risk and some supervisors would wish to use a more conservative approach. This is because while the treatment laid down in the Capital Accord may be suitable for measuring the credit risk in a portfolio of derivatives products, it is not necessarily appropriate for large exposure purposes where a "worst-case" and therefore more rigorous approach may be justified.

II. Work currently in progress which impacts on banks' derivative activities

The Basle Committee is currently engaged in work in a number of different areas which takes account of the derivatives activities of banks.

(a) Market risk

1. In April 1993 the Committee issued a set of proposals to extend the 1988 Capital Accord to incorporate foreign exchange risks in the bank as a whole and the price risks in traded debt and equity instruments. These proposals, which are currently being reviewed in the light of practitioners' comments inevitably focus close attention on the measurement of price risks in derivatives.

2. The treatment of derivatives is spelled out at some length in the proposals. All types of derivatives are covered, in several cases allowing a choice between simple and sophisticated alternatives. The most difficult instruments to incorporate are options and other instruments with option-like features because of the non-linear nature of the price risk. At an early stage of the work, it was concluded that the only easy way to convert options into a measure which could be added to cash positions was to multiply the options position by the hedge ratio (i.e. delta). However, since deltas do not capture all the risk in options, this method needed to be supplemented by some form of "add-on" if it was to be used as a supervisory measure. In the 1993 proposal, this was one of a number of possibilities on which the market's views were invited, together with a very simple alternative for banks which only buy options as hedges and the possibility of using option pricing models.

3. Among the many comments received on the market risk proposals are two common themes that concern the treatment of derivatives. One relates to the overall approach,

arguing that the market risks run by the major market participants are now too complex to be captured by a measurement system that makes such simplified assumptions about the interaction of various market risk parameters and that only address linear market risk. Thus, for banks with large and diversified trading books, with complex derivatives positions, the proposals were said to produce less accurate results than banks' internal measurement systems, at considerable computational cost. The other comment relates specifically to options, where the market agreed that it is imprudent to rely solely on deltas to measure price risk. The Committee is reviewing these points, and a whole range of additional issues, and hopes to produce a revised set of proposals in due course. In particular, it is exploring the possibility of permitting banks to use their in-house models to measure their risks, subject to a number of carefully devised safeguards.

4. The Basle Committee believes that putting into place market risk capital requirements is important in the context of addressing the overall risk in derivatives markets. Its priority in the period ahead is thus to obtain the industry's final input on a revised proposal for a market risk measurement framework and associated capital charges.

5. Early in the Committee's work on market risk it became clear that introducing capital charges on the portfolios of traded debt and equities had important implications for banks' competitive positions in the securities markets and it would be preferable to develop an approach jointly with the regulators in these markets. Although no joint approach has been agreed to date, the Basle Committee has not given up hope that in due course banks and securities regulators may be able to reach a common understanding on a framework of regulation for market risk which could apply to both banks and securities houses. In this regard, the European Union has developed common rules for banks and securities houses operating within the Union.

(b) Netting

6. As mentioned in Section I the 1988 Capital Accord allows banks to net the credit risk in respect of forward obligations subject to bilateral netting by novation but does not recognise close-out netting. Following the issue in November 1990 of the Lamfalussy report on Interbank Netting Schemes, the Basle Committee reconsidered the treatment of netting in the Capital Accord and decided to revise it to recognise, in addition to netting by novation, other forms of bilateral netting of credit exposures to the extent that such arrangements are effective under relevant laws and comply with the other relevant principles described in the Lamfalussy Report. This intention was announced together with the market risk proposal in April 1993. The proposal to recognise bilateral netting was subsequently confirmed by a formal revision to the Capital Accord issued in July 1994.

7. The Committee shares the conclusion in the Lamfalussy Report that netting arrangements for both interbank payment orders and forward-value contractual commitments such as foreign exchange contracts and swaps have the potential to improve both the

efficiency and the stability of interbank settlements, by not only reducing costs but also credit and liquidity risks. The revision to the Capital Accord therefore recognises bilateral netting for forward-value contractual commitments where the appropriate national supervisors are mutually satisfied that agreed minimum legal requirements are met. Banks will have to maintain written and reasoned legal opinions confirming the legal validity of the netting contracts for supervisory review purposes. After consultation when necessary with other relevant supervisors, the supervisor must be satisfied that the netting is enforceable under the laws of each relevant jurisdiction. For banks using the current exposure method, the credit exposure on bilateral netted forward transactions will be calculated as the sum of the net marked-to-market replacement cost, if positive, plus an add-on based broadly on notional underlying principal.[4] For banks now using the original exposure method, a reduction in the credit conversion factors applied to bilaterally netted transactions will be permitted on a temporary basis until the market risk-related capital requirements are implemented. At that time the original exposure method will cease to be available (although there will be an additional transition period allowed in certain cases, but in no case longer than 12 months).

8. As a by-product to the wider recognition of netting, the Committee also examined the issue of "walkaway clauses" (a provision which permits a non-defaulting counterparty to make only limited payments, or no payment at all, to the estate of a defaulter, even if the defaulter is a net creditor). Since walkaway clauses introduce an element of instability and uncertainty which the Committee sees as unsuitable in a netting environment, it has deemed that any netting arrangement which contains walkaway clauses will not be considered as qualifying for netting.

9. The April 1993 proposal also discussed the application of capital charges to multilateral netting schemes in which participants reduce their credit risks by netting their forward obligations to fellow participants in the scheme. Such arrangements may require participants to provide liquidity support or to contribute to loss-sharing arrangements if one of the members defaults. There is also a remote risk of a chain of defaults. The Committee has not yet determined how it will recognise netting in such an environment, but it will be looking carefully at this matter over the next few months in the light of the ongoing development of two foreign exchange netting schemes in Europe and North America.

(c) Enlarging the add-ons matrix

10. The Basle Committee has recently issued a proposal to enlarge the "add-ons matrix" for applying capital charges to potential future exposure in derivatives. Two different

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[4] In its July 1994 paper stipulating the conditions for implementing netting, the Committee proposed a formula for calculating the add-ons for netted books, which would result in some reduction in the add-ons for contracts subject to enforceable netting arrangements. The comment period for this proposal ended in October and the comments are currently being reviewed.

problems have been addressed. First, it has been decided that the matrix should cover explicitly and more accurately equity, precious metals and other commodity contracts; the present matrix only makes a distinction between interest rate and foreign exchange contracts.[5] Second, the Committee has concluded that the existing distinction between maturities of less than one year and those of one year or over for specifying the add-ons may be inadequate to cover the exposure associated with longer-term contracts. As a result, it has decided to introduce a third maturity breakdown, over five years, with correspondingly higher capital charges. The proposals to make this change to the Accord were contained in the release of July 1994, with comments invited by 10th October 1994.

(d) Interest rate risk

11. For many years the Basle Committee has been attempting to devise and to put in place an agreed measure of interest rate risk applicable to all assets and liabilities which are sensitive to movements in interest rates (i.e. not only to items in the trading book captured in the market risk exercise). The 1988 Capital Accord stated that the Committee would be looking into the possibility of incorporating a measure of interest rate risk and that, in the meantime, some members would apply a capital charge to government securities (which bear no credit risk) as a proxy for interest rate risk.

12. Measuring interest rate risk has proved extremely difficult because of the uncertainty associated with specifying the maturity of certain assets and liabilities. Derivatives positions have not raised particular difficulties, except in the case of options, where the date of exercise of an option can be uncertain. A general issue which affects derivatives is how to treat positions in the trading book for purposes of measuring interest rate risk for the whole bank.

13. The April 1993 market risk package included a discussion paper inviting comment on a proposed measurement system for interest rate risk, with a view to using that as a basis for Committee members to identify so-called "outliers" (i.e. institutions whose interest rate risk is at the higher end of the spectrum in comparison with similar institutions). The Committee stated that existing capital requirements could be regarded as covering a certain amount of interest rate risk, and that - for the time being- even the treatment of outliers would be left to national discretion. Nonetheless, interest rate risk remains an important risk of considerable concern to supervisors and the Committee will continue to investigate supervisors' options.

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5 Hitherto, most Committee members have ruled that the add-ons for equities, precious metals and commodities should be those applicable for foreign exchange contracts.

III. Strengthening banks' management of derivatives activities

1. As supervisors have been stressing ever since the 1986 statement referred to in I(a) above, derivatives pose significant operational and control risks for banks, and it is essential for them to have in place comprehensive systems to ensure that the board of directors and senior management can monitor their derivatives activities. A statement in early 1992 by the Committee's then Chairman, Mr. Corrigan, that he was concerned that this message was not getting through strongly enough occasioned considerable publicity, as it was designed to do. The reactions have been positive both at the level of the individual bank and at industry level. However, in an environment in which developments take place so rapidly, supervisors must continue to emphasise to banks the need to update and improve their risk management systems. Several Committee members have in the recent past issued guidelines to their banks on sound risk management of derivatives activities.

2. To reinforce this message the Basle Committee issued a paper in July 1994 that sets out for supervisors' guidance the main elements of sound risk management, drawing where appropriate on national guidelines and on the recommendations of the industry. Individual supervisors are free to draw on the paper in setting out guidelines or sound practices for their own banks, or to circulate it to banks in its entirety. The paper stresses that the basic elements of sound risk management used by banking institutions in their traditional banking functions are equally applicable for derivatives instruments. These basic elements include: (i) appropriate oversight by boards of directors and senior management; (ii) adequate risk management process that integrates prudent risk limits, sound measurement procedures and information systems, continuous risk monitoring and frequent management reporting; and (iii) comprehensive internal controls and audit procedures.

3. The July paper was issued jointly with similar guidelines for securities supervisors issued by the Technical Committee of the International Organisation of Securities Commissions. Although the documents differ in structure and detail, the principles they embody are similar. A joint press statement emphasised the importance that both bank and securities supervisors place on sound internal risk management for the prudent operations of individual institutions and for promoting stability in the financial system generally.

4. A particular aspect of concern in banks' risk management techniques in relation to derivatives is the increasing use of statistical models by the major banks as the principal means of measuring and managing risk. As already mentioned, the Committee is considering the possibility of allowing banks which can meet certain strict conditions to use their internal models as a basis for measuring the capital charges for market risk. A considerable amount of work has already been done at the technical level to learn about modelling techniques, but the work needs to be broadened if the use of models is to become a significant supervisory tool. It is becoming increasingly important for supervisors to be able to check the reliability of the

models used by banks to measure and control their risks, although it is recognised that this raises difficult questions of training and resources for the supervisory authorities.

5. A key aspect of the reliance on banks' internal models to measure their exposures is to enforce a credible validation process. There are two elements in the validation process: the soundness of the conceptual approach and the maintenance of the system's integrity. Ensuring the soundness of the conceptual approach must be based principally on a continuous effort by the bank itself to ensure that its model is accurate and updated for recent events, changes in the trading environment and changes in the bank's business activities. Risk measures need to be compared with results and the model refined where necessary.

6. The integrity of the risk management system has to be maintained by an ongoing audit process, in which the statistical input and the actual calculations are periodically checked by both internal and external auditors. Supervisors need to be able to review the audit papers and perform independent checks of data quality and transmission procedures as well as the assumptions imbedded in the system. It is important for supervisors to establish an on-going dialogue with banks and other supervisors concerning validation issues.

IV. Payments and settlements issues

1. Derivatives transactions, and the strategies associated with them, spawn important market linkages because they can be cross-border, can involve the settlement of large-value cash flows in a number of currencies and can require the completion of trades in underlying cash and other derivatives markets. Payments, clearance and settlement systems provide infrastructure necessary to support these activities. They are conduits through which stress at one firm or in one market may be transmitted to others, and therefore are a nexus for supervisory concerns about the insolvency of individual institutions and the stability of the financial system.

2. The Basle Committee's work has had and will continue to have important implications in this area. Under its amendment to the Capital Accord broadening the recognition of bilateral netting (see II(b) above), the Committee is providing an additional incentive for banks to enter into credit risk-reducing arrangements for certain forward obligations, including derivatives, subject to solid legal assurances. Without such a foundation, there is an increased likelihood that netting will not take place in accordance with the terms of the agreement, which could have adverse consequences for the counterparties, and by extension, the financial system.

3. With respect to multilateral netting, the Capital Accord already recognises the risk-reducing effects of futures-style margining by not requiring any capital for credit risk to support transactions on an exchange whose clearing house employs such a daily margining process. The Committee, however, continues to develop a workable proposal for the capital adequacy treatment of OTC multilateral contract netting systems. Properly structured, such

systems would reduce credit and liquidity risks associated with clearing and settling forward trades. A well-designed capital rule would provide additional incentives for market participants to join a risk-reducing arrangement while providing a reasonable level of prudential coverage for forward exposures in these systems. Although the multilateral systems currently under development are for foreign exchange contracts, such a capital rule would also cover a system designed for OTC derivatives, for example swaps contracts, should the market attempt to establish one. Before these systems become operational, they will first have to meet the minimum standards set out by the Lamfalussy report. Amongst other requirements a scheme should have a well-founded legal basis under all relevant jurisdictions and should have adequate liquidity to ensure the timely completion of daily settlements. Central banks are engaged in detailed discussion of these issues with the sponsors of the multilateral systems currently under development.

V. Supervisory reporting, public disclosure and accounting

1. There is widespread recognition that present accounting, supervisory reporting and public disclosure standards and practices for derivatives are not comprehensive, consistent or as informative as they could be. As a consequence, meaningful international comparison of derivatives activities and the riskiness of these activities among banks and other financial institutions is difficult. Standards and practices have not, and perhaps could not, keep pace with rapidly changing technologies, the integration of the world's financial markets and the growth in financial derivatives and other trading activities. This situation is not unique to derivatives; it applies to other aspects of banks' activities that have become so complex that current accounting, reporting and disclosure standards do not provide a sufficiently accurate picture of the bank's risk profile.

2. The Basle Committee's primary concern in this area is to see that supervisors receive sufficient information to assess adequately banks' derivatives activities and the related risks. *Reporting* is the foundation for their on-going analysis of the financial condition of banks as well as the basis for comparative analyses. It consists basically of quantitative information gathered through routine reports, examination and/or external audit. Such reports also need to be supplemented by qualitative information. The central focus of the Committee's effort will therefore be to determine what information supervisors might need in order to make an adequate assessment of banks' derivatives activities and the risks involved in these activities. Recognising the need to minimise the frequency of changes to supervisory reporting requirements, the Committee is aiming to develop some basic principles and an analytical framework to guide banks' supervisory reporting. In doing so, it will also pay due regard to the framework for global market statistics under development by the Euro-currency Standing Committee of G-10 central banks to improve market transparency and to monitor

the macro-prudential and macro-economic implications of derivatives markets (the so-called Brockmeijer report).

3. At the same time, it is necessary to review what types of information might usefully be subject to *public disclosure*. The public disclosure of financial accounts, capital positions, accounting practices and qualitative information about the use of derivatives permits more informed decisions by counterparties. In addition, it gives senior bank management a strong incentive to focus on the underlying risk management process. Inadequate disclosure reduces the transparency, not only of an individual firm's exposures and sources of income, but also of the financial system as a whole. This in turn has the effect of depriving market participants of information essential to their portfolio choices and may inhibit the authorities' ability to assess and respond to a troubled firm or to market stress.

4. With a view to encouraging improved public disclosure by financial intermediaries, the Bank for International Settlements published in September this year a discussion paper prepared by a task force of the Euro-currency Standing Committee which recommends a framework for the disclosure of market and credit risk based on firms' internal risk management and performance assessment systems (the so-called Fisher report). The Basle Committee believes that the recommendations of the Fisher report merit careful consideration by the financial community. Market participants clearly recognise the need for improved disclosure to permit more informed market decisions. Although bank supervisors in a number of countries have relatively little say in public disclosure, the Basle Committee encourages the industry to build on the initiatives announced by the Group of Thirty and the Institute of International Finance, among others, and it also welcomes the initiatives by national accounting bodies which are intended to improve disclosures related to derivatives, such as FASB Standard No. 119.

5. In this complex, rapidly changing environment, well thought out definitions of measurement techniques will be an important foundation for advancing public disclosure. The past work of the Basle Committee in the area of credit risk, notably in relation to the development of the concept of replacement cost, has provided a framework on which public disclosures of banks' credit exposures in their derivatives activities are frequently based. The Committee hopes that its work on market risk referred to in II(a) above will prove to be an important element in the ongoing process of defining commonly accepted measures of market risk.

6. *Accounting* standards are a critical element for supervision, public disclosure and market discipline. They provide the foundation for credible and comparable public financial statements and supervisory reports. Accurate and timely financial information provide the basis for decisions by management, counterparties, analysts, investors and supervisors. Although supervisors in general have no direct authority in the accounting area, the

Committee believes that its individual members can frequently assist in the development of appropriate and consistent accounting standards and practices.

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