

Recent initiatives by the Basel-based committees and groups

During the period under review, the Basel Committee on Banking Supervision (BCBS) released a consultative document on principles for home-host supervisory cooperation and allocation mechanisms in the context of Advanced Measurement Approaches (AMA) for operational risk. The Financial Stability Forum (FSF) initiated an update of its work on hedge funds, and held a meeting with officials from the European region. The Committee on Payment and Settlement Systems (CPSS) announced new developments in clearing and settlement arrangements for over-the-counter (OTC) derivatives. Table 1 provides an overview of these and other developments.

Basel Committee on Banking Supervision

BCBS releases consultative document on:

On 7 February 2007, the BCBS released a consultative document on *Principles for home-host supervisory cooperation and allocation mechanisms in the context of Advanced Measurement Approaches (AMA)*. The paper, which was open for comments until 18 April 2007, sets out principles related to two important topics in the implementation of the AMA for operational risk under Basel II.¹ The first set of principles is intended to be a supplement to the paper *Home-host information sharing for effective Basel II implementation* (home-host paper) as it focuses specifically on supervisory cooperation in the context of banks implementing an AMA. The second set of principles builds on the paper *Principles for the home-host recognition of AMA operational risk capital* (hybrid AMA paper) and specifically addresses allocation mechanisms developed as part of a hybrid AMA.

principles for home-host cooperation on AMA methodologies and implementation ...

First, the new paper sets out to clarify the key elements of supervisory cooperation with respect to the implementation of AMA and to establish a framework of principles to facilitate information sharing in the assessment and approval of AMA methodologies. The paper notes that the implementation of Basel II, particularly the AMA, by international banking groups presents unique

¹ The principles set out in this paper do not supersede the general principles described in the paper *High-level principles for the cross-border implementation of the New Accord* but rather provide further elaboration of these principles in an operational risk context. Also, to the extent that this paper refers to operational risk capital requirements, such references are limited to the Pillar 1 capital charge only.

Main initiatives by Basel-based committees and groups			
Press releases and publications over the period under review			
Body	Initiative	Thematic focus	Release date
BCBS	<i>Principles for home-host supervisory cooperation and allocation mechanisms in the context of Advanced Measurement Approaches (AMA) – consultative document</i>	<ul style="list-style-type: none"> • Key elements of supervisory cooperation with respect to the implementation of AMA; framework of principles to facilitate information sharing in the assessment and approval of AMA methodologies • Set of principles to promote the development and assessment of allocation mechanisms incorporated in a hybrid AMA 	February 2007
FSF	<i>Second FSF European regional meeting</i>	<ul style="list-style-type: none"> • Assessment of strengths and vulnerabilities in regional financial systems • Coordination for home and host authorities in respect of cross-border financial groups • Prioritisation of financial system reforms • Progress in developing domestic capital markets 	January 2007
	<i>Update of report on highly leveraged institutions (HLIs)</i>	<ul style="list-style-type: none"> • Reassessment of risks posed by hedge funds and steps that can be taken to mitigate these risks 	February 2007 (request)
	<i>Seventeenth meeting of the FSF</i>	<ul style="list-style-type: none"> • Review of ongoing work to strengthen financial system stability and resilience • Assessment of risks and vulnerabilities in the international financial system • Developments in credit risk transfer 	March 2007
CPSS	<i>New developments in clearing and settlement arrangements for OTC derivatives</i>	<ul style="list-style-type: none"> • Findings of a working group set up in early 2006, based on discussions with the industry • Assessment of the OTC derivatives clearing and settlement infrastructure • Areas for further progress and important outstanding issues 	March 2007
Source: Relevant bodies' websites (www.bis.org , www.fsforum.org).			Table 1

information sharing needs. While communication between home and host supervisors is important, banks play the primary role in implementing Basel II and providing relevant information to home and host supervisors to allow them to meet their responsibilities. The paper then proceeds to outline the factors influencing information sharing, as well as its scope, frequency and mechanics. Finally, it dwells on the responsibilities of banks in the area of information sharing. The document provides examples of information sharing for effective AMA implementation.

Second, the paper sets forth general principles to promote the development and assessment of allocation mechanisms incorporated in a hybrid AMA. These principles relate to: risk sensitivity, capital adequacy, subsidiary level management support, integration into Pillar 1, stability, implementation, documentation, internal review and validation, and supervisory assessment.

... and for allocation mechanisms in a hybrid AMA

Financial Stability Forum

At the request of the G7 Ministers and Governors, the FSF is preparing an update of its earlier work on highly leveraged institutions (HLIs). The FSF has also asked the Joint Forum to revisit an earlier report on the credit risk transfer (CRT) market in light of the continued rapid pace of growth and innovation. The FSF took stock of these and other initiatives relating to financial stability at its seventeenth meeting in Frankfurt in March 2007, and discussed regional issues with counterparts from northern and eastern Europe at its second European regional meeting in Stockholm in January 2007.

FSF receives
request to update
report on HLIs ...

In February 2007, the G7 Finance Ministers and central bank Governors asked the FSF to prepare an update of its 2000 report on *highly leveraged institutions*, to be submitted to the G7 in May. Since 2000, the role of hedge funds in price discovery, market liquidity and risk-bearing in markets has increased. The update, which will draw on input from the FSF member institutions, will review the supervisory, regulatory and private sector actions taken in recent years to strengthen market discipline, risk management practices and market infrastructure and make recommendations for further risk-mitigating action by the public and private sectors.

... and reviews
progress

Members reviewed progress in this work at the FSF's *seventeenth meeting*, which was held in Frankfurt on 29 March 2007. They discussed how financial institutions are responding to the counterparty credit risks posed by hedge funds, including developments in collateral, margining and stress testing practices. More broadly, members emphasised the importance of enhancing the effectiveness of market discipline and continuing attention by supervisors to strengthening counterparty risk management practices.

Stocktaking on the
CRT markets

Regarding the CRT markets, participants noted that while rapid innovation in CRT instruments has facilitated the management and diversification of credit risk, questions remain about how these instruments might behave during a period of stress. Members discussed steps that can be taken to strengthen the underpinnings of CRT activity, including strengthening infrastructure, improving transparency and enhancing stress testing. They asked the Joint Forum to revisit its 2005 report on CRT in view of the continued rapid growth and innovation in these markets since then. The Forum also asked the Committee on the Global Financial System (CGFS) and the International Organization of Securities Commissions (IOSCO) to reassess previous reviews of the role of credit rating agencies in the structured credit markets.

Forum analyses
recent turbulence in
equity and credit
markets

Forum members also exchanged views on other risks and vulnerabilities in the international financial system. They noted that turbulence in equity and credit markets in late February and early March involved an adjustment in risk positions amidst some increase in macroeconomic uncertainty and concern about the scope of problems in the US subprime mortgage sector. The episode illustrated the extent of linkages among risk premia in different asset classes in the current environment. The Forum urged market participants to ensure that risk management scenarios take appropriate account of the risks and potential consequences that would arise from a more pronounced and prolonged reduction of risk-taking. Finally, the Forum followed up on other ongoing concerns, including assessing work and initiatives

currently under way to promote effective and efficient regulation, to plan and set up communication channels for financial crises and business continuity incidents, and to address remaining problems regarding offshore financial centres' compliance with international standards. Members received a report from the Chairman of the International Forum of Independent Audit Regulators on work at the international and national levels to improve audit quality. They also welcomed work by the International Association of Insurance Supervisors to improve transparency in the global reinsurance market, and by the CPSS and World Bank to strengthen the structures supporting international remittance services.

The Forum held its *second European regional meeting* in Stockholm on 22–23 January, bringing together senior representatives from finance ministries, central banks and supervisory and regulatory authorities from seven FSF member countries and 16 regional non-member countries, as well as senior officials from international and regional financial institutions.

Participants exchanged views on strengths and vulnerabilities in the global and regional financial systems, particularly in central and eastern Europe. They noted that cross-border financial flows, rapid credit expansion and current and prospective membership in the European Union have provided additional impetus to market growth in central and eastern Europe. Regional financial systems are developing rapidly and are generally in good condition.

One by-product of these developments for the region has been rapid growth of private sector credit, a significant share of which in some countries is denominated in foreign currency. Sustained high credit growth largely reflects robust domestic demand, low real interest rates and a catching-up process with the levels of private sector credit in advanced economies. However, participants noted several sources of potential risk, including the consequences of strong competition in lending markets, developing credit assessment processes, and exposure to foreign exchange risks by unhedged borrowers. Participants discussed the effectiveness of policy measures that have been taken to mitigate these risks.

FSF notes rapid growth of private sector credit in central and eastern Europe

Participants also exchanged views and experiences on a number of other issues, including the role of cross-border financial groups, prioritisation of financial system reforms, and progress in developing domestic capital markets.

Committee on Payment and Settlement Systems

On 16 March 2007, the CPSS published a report on *New developments in clearing and settlement arrangements for OTC derivatives*. In early 2006, the CPSS had set up a working group, comprising representatives of its member central banks and prudential supervisors of major derivatives dealers, to analyse existing arrangements and risk management practices in the broader OTC derivatives market and to evaluate the potential for risks to be mitigated by greater use of, and enhancements to, market infrastructure.²

CPSS report on OTC derivatives clearing and settlement ...

² See "Recent initiatives by Basel-based committees and the Financial Stability Forum", *BIS Quarterly Review*, June 2006, pp 77–83.

The report, open for comments and based on interviews and meetings with major dealers in OTC derivatives, industry groups and providers of post-trade processing services, focuses on six issues:

- the risks created by delays in documenting and confirming transactions;
- the implications of the rapidly expanding use of collateral to mitigate counterparty credit risks;
- the potential for expanding the use of central counterparty (CCP) clearing to reduce counterparty risks;
- the implications of OTC derivatives prime brokerage;
- the risks associated with unauthorised novations of contracts; and
- the potential for significant market disruptions from the closeout of OTC derivatives transactions following the default of a large market participant.

Some of these issues had already been discussed in 1998 and others have attracted the group's attention during its discussions with OTC derivatives dealers and service providers.³

... notes stronger clearing and settlement infrastructure ...

The report concludes that, since 1998, the clearing and settlement infrastructure of OTC derivatives markets has been significantly strengthened, but further progress is needed to reduce confirmation backlogs in products other than credit derivatives, where efforts have until now been concentrated. In addition, market participants should work together to identify further steps that could be taken to mitigate the potential market impact of the closeout of one or more major participants. The report formulates concrete proposals for making progress in these areas. Lastly, it highlights two issues that will assume greater importance as the market infrastructure moves further in the direction of centralised processing of trades and post-trade events. First, providers of essential post-trade services for OTC derivatives should allow open access to their services and should aim to achieve convenient and efficient connectivity with other systems. Second, central banks and supervisors will need to consider whether certain existing standards for securities settlement systems, CCPs or systemically important payment systems should be applied to providers of clearing and settlement services for OTC derivatives that are not already subject to those standards.

... and makes proposals for further progress

In March 2007, an update was issued of the *Statistics on payment and settlement systems in selected countries – Figures for 2005*. The preliminary version, published in November 2006, did not include some data for 2005 that were not available at the time.

³ Some of these issues were also described in *Toward greater financial stability: a private sector perspective* (July 2005), the report of the Counterparty Risk Management Policy Group II (CRMPG II), a private sector group chaired by E Gerald Corrigan.