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Recent initiatives by the Basel-based committees and groups

During the period under review, the Basel Committee on Banking Supervision (BCBS) released a report on fair value measurement, as well as consultative documents on sound liquidity risk management and supervision, and on an incremental risk capital charge. The Committee on the Global Financial System (CGFS) issued three reports analysing important issues pertinent to the financial market turmoil that broke out in mid-2007. The Committee on Payment and Settlement Systems (CPSS) published reports on foreign exchange settlement risk and on the interdependencies of payment and settlement systems. Thanks to these initiatives and others at the national and international levels, good progress was made on implementing the recommendations made by the Financial Stability Forum (FSF) in April 2008. Table 1 provides an overview of these and other developments.

Basel Committee on Banking Supervision

BCBS releases publication on fair value measurement and modelling …

On 12 June, the BCBS released a publication on *Fair value measurement and modelling: an assessment of challenges and lessons learned from the market stress*. Drawing on the work of the Committee's Accounting Task Force and Risk Management and Modelling Group, the paper summarises the Committee's initial assessment of valuation practices. It identifies four key areas in which practices can be improved: governance and controls; risk management and measurement; valuation adjustments and uncertainty; and financial reporting.

… and is undertaking further work on the subject

To strengthen practices and promote greater transparency regarding valuation processes, the Committee is undertaking further work to develop guidance that supervisors can use to assess the rigour of banks' valuation processes and promote improvements in risk management and control practices. The Committee will also work with accounting and auditing standard setters and auditors to promote standards and practices that enhance the reliability, verifiability and transparency of fair value estimates. These initiatives will build on existing BCBS and industry guidance. They are also part of a broader effort by the Committee and national supervisors to strengthen firm-wide risk management practices.

Initiatives by Basel-based committees and groups

Press releases and publications over the period under review

Body	Initiative	Thematic focus	Release date
BCBS	*Fair value measurement and modelling: An assessment of challenges and lessons learned from the market stress*	• Summary of Committee's initial assessment of valuation practices • Identification of areas for improvement of practices • Steps forward	June 2008
	Principles for sound liquidity management and supervision	• Revision of earlier sound practices published in 2000 • Proposals to raise standards in the areas of governance and firm-wide risk tolerance, liquidity risk measurement, risk-taking incentives for individual business units, stress testing, intraday liquidity risks and collateral, the establishment of liquidity cushions, public disclosures and supervision	
	Guidelines on an incremental risk charge and accompanying revisions to the Basel II Framework	• Aligning regulatory capital requirements with the risk exposure of banks' trading book positions	July 2008
CGFS	*Private equity and leveraged finance markets*	• Trends during the period of rapid growth • Performance since mid-2007 • Short-, medium- and long-term risks	July 2008
	Ratings in structured finance: what went wrong and what can be done to address shortcomings?	• Recommendations on improving the information provided on ratings of structured finance products • Summary of the feedback received during consultation with credit rating agencies and investors	
	Central bank operations in response to the financial market turmoil	• Summary of central bank actions • Assessment of the outcome • Policy recommendations	
CPSS	*Reducing foreign exchange settlement risk*	• Assessment of progress made • Recommendations to reduce and control remaining large and long-lasting exposures	May 2008
	Interdependencies of payment and settlement systems	• Various interdependencies among the systems of CPSS countries • Risk implications of these interdependencies; associated risk management challenges	June 2008
FSF	*Report by the FSF Chairman to the G8 Finance Minsters*	• Current situation of the financial system • Implementation of the recommendations of the FSF *Report on enhancing market and institutional resilience* • Future work of the FSF	June 2008

Source: Relevant bodies' websites (www.bis.org, www.fsforum.org). Table 1

BCBS publishes consultative document on sound liquidity management and supervision …

On 17 June, the Committee released for public comment a consultative document on *Principles for sound liquidity management and supervision*. The enhanced global standards reflect the lessons of the financial market turmoil and represent a substantial revision of the Committee's *Sound practices for managing liquidity in banking organisations* that were published in 2000. The principles draw on recent and ongoing work on liquidity risk[1] by the public and private sectors and are intended to strengthen banks' liquidity risk management and improve global supervisory practices. They support one of the key recommendations for strengthening prudential oversight set out in the *Report of the Financial Stability Forum on enhancing market and institutional resilience*, which was presented to G7 Finance Ministers and central bank Governors in April 2008.

… outlining the importance of a robust, bank-wide risk management process …

The principles underscore the importance of establishing a robust liquidity risk management framework that is well integrated into the bank-wide risk management process. The primary objective of this guidance is to raise banks' resilience to liquidity stress (impairment of secured or unsecured funding, the source of which can be market- or bank-specific). The principles seek to raise standards in the following areas:

- governance and the articulation of a firm-wide liquidity risk tolerance;
- liquidity risk measurement, including the capture of off-balance sheet exposures, securitisation activities, and other contingent liquidity risks that were not well managed during the financial market turmoil;
- aligning the risk-taking incentives of individual business units with the liquidity risk exposures their activities create for the bank;
- stress tests that cover a variety of institution-specific and market-wide scenarios, with a link to the development of effective contingency funding plans;

… and seeking to raise standards in specific areas

- strong management of intraday liquidity risks and collateral positions;
- maintenance of a robust cushion of unencumbered, high-quality liquid assets to be in a position to survive protracted periods of liquidity stress;
- regular public disclosures, both quantitative and qualitative, of a bank's liquidity risk profile and management;
- supervisory approaches to periodic and ongoing assessment of a bank's liquidity position[2] and risk management framework, as well as the utilisation of remedial action when necessary.

The document was open for comment until 29 July 2008.

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[1] In this context, liquidity is the ability of a bank to fund increases in assets and meet obligations without incurring unacceptable losses. Liquidity risk thus means the risk of not being able to obtain such funding or meet obligations.

[2] A bank's liquidity position is a point-in-time measure of its ability to fund increases in assets and meet obligations as they come due, without incurring unacceptable losses. Determining a bank's liquidity position therefore requires an understanding of a number of factors that affect its liquidity at the relevant point in time, such as the bank's cash flow mismatch, the size of its cushion of unencumbered, highly liquid assets, the market liquidity of its assets and the certainty of its access to various sources of funds, among others.

On 17 July, the BCBS released for public comment its preliminary views on supervisory expectations relating to *due diligence and transparency regarding cover payment messages related to cross-border wire transfers*.

BCBS invites comments on due diligence and transparency principles in the area of cross-border wire transfers

The processing of cross-border wire transfers frequently involves several financial institutions. In addition to the originator's bank and the beneficiary's bank, other banks are often involved. This paper examines the circumstances where one or more of these intermediary banks is located in a jurisdiction other than the jurisdictions where the bank of the originator and the bank of the beneficiary are located. It describes the supervisory expectations, pursuant to the current initiatives supported by the Basel Committee to enhance transparency in payment messages, about information that must be included in payment messages related to cover payments, the various mechanisms that must be used to ensure that complete and accurate information has been included in such messages, and the use that should be made of the information for AML/CFT purposes.

The document is open for comment until 16 September 2008.

On 22 July, the Committee released for comment *Guidelines for computing capital for incremental risk in the trading book*. This followed the consultation paper released in October 2007 on proposed guidelines for computing capital for incremental default risk, or the risk that is incremental to the default risk already reflected in a bank's value-at-risk (VaR) model. Reflecting comments received and the experience of the recent turmoil, the Committee has expanded the scope of the capital charge to more fully capture the sources of recent losses in CDOs of ABS and other resecuritisations held in the trading book, which arose not from actual defaults but from credit migrations combined with widening of credit spreads and the loss of liquidity.[3] The proposed incremental risk charge (IRC) would capture price changes due to defaults as well as other sources of price risk, such as those reflecting credit migrations and significant moves of credit spreads and equity prices.

BCBS issues for comment guidelines for computing capital for incremental risk in the trading book …

In its *Proposed revisions to the Basel II market risk framework*, the BCBS also proposes improvements concerning internal VaR models. It has further aligned the language with respect to prudent valuation for positions subject to market risk with existing accounting guidance. In addition, it has clarified that regulators will retain the ability to require adjustments to current value beyond those required by financial reporting standards, in particular where there is uncertainty around the current realisable value of a position due to (market) illiquidity.

… together with improvements to Basel II regarding internal VaR models

The guidance would become effective for implementation by 1 January 2010 for default and migration risk and by 1 January 2011 for all remaining price risks. It was developed jointly by the Basel Committee and the International Organization of Securities Commissions (IOSCO). In conjunction with the proposed guidelines, the Committee will conduct a two-stage quantitative impact study of the IRC on firms' capital requirements. In the first

[3] Market liquidity, or the ability to trade on short notice without incurring unacceptable losses.

stage, the Committee plans to rely largely on data collected in connection with the 2007 incremental default risk proposal to examine the impact of incorporating default and migration risk into the IRC. In stage two, additional data will be collected to examine the impact of incorporating other risks.

The consultative documents are open for comment until 15 October 2008.

Committee on the Global Financial System

On 4 July, the CGFS published three reports analysing important issues pertinent to the financial turmoil that broke out in mid-2007, in the areas of private equity and leveraged finance markets, ratings in structured finance and central bank operations in response to the financial turmoil.

CGFS releases report on private equity and leveraged finance markets …

The report on *Private equity and leveraged finance markets* was prepared amidst rapidly deteriorating conditions in leveraged finance[4] markets. Against this backdrop, the report addresses two broad questions. First, what have been the important trends during the period of rapid growth in the markets for leveraged finance, private equity and leveraged buyouts (LBOs), and how has market growth affected financing patterns? Second, how have leveraged finance markets performed since mid-2007, which risks have surfaced, and what preliminary lessons can be drawn for financial stability?

… summarising development trends …

On the first question, the report finds evidence of more rapid growth in leveraged loan issuance in recent years than issuance of high-yield bonds. At the same time, institutional investors have replaced banks as the main investors. Collateralised loan obligation[5] (CLO) vehicles have emerged as loan securitisers and intermediaries. Increased ratings coverage of the loans has further attracted institutional investors. There has been increased secondary market trading of leveraged loans, and bank business models have shifted from “buy and hold” to “originate to distribute” (OTD).

… highlighting risks that have arisen since mid-2007 …

… in particular, warehousing risk …

On the second question, the report notes that conditions in the leveraged loan market deteriorated in the second half of 2007 and demand for leveraged finance declined sharply. The contraction in demand for leveraged loans, especially by securitisation vehicles,[6] revealed substantial exposure of arranger banks to warehousing risk. Undistributed loans, in conjunction with other off-balance sheet products that banks have been forced to move onto their balance sheets during the credit market turmoil, have contributed to increased funding costs and capital requirements.

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4 Financing, typically for takeovers, ensuing in a high level of leverage for the borrower.

5 Bonds backed by the cash flow on a pool of loans. Structured finance consists in issuing securities backed by the cash flows on a pool of homogeneous assets. The securities are often divided into tranches, each corresponding to a particular riskiness, depending on guarantees attached to each tranche and on their seniority for the collection of payment (interest and principal) streams.

6 Such vehicles, which had become major investors in leveraged loans in recent years, had influenced the characteristics of leveraged loans through their sustained demand for covenant-lite and long-maturity loans.

The report highlights a number of risks. In the short term, there are risks associated with an unwanted expansion of bank balance sheets from undistributed leveraged loans. This may impair banks' ability to provide liquidity (ie short-term funding) and bridge financing, in a period when the high-yield bond market may not be able to act as a "spare tyre" for corporate funding. In the medium term, a tightening of financing conditions may lead to substantially higher refinancing risks for highly leveraged firms. This, together with the expected pressure on firms' future cash flows stemming from a weakening economy, will further increase the default risk of firms dependent on leveraged finance. In the long term, the terms and availability of leveraged finance and the capacity of private equity participants to fund LBO deals will depend on modifications to the OTD model. Finally, the greater diversity of investors in the leveraged finance market may raise the duration and cost of the debt restructuring process, with potential implications for default risk and the dynamics of the corporate credit cycle.

… a tightening of financing conditions …

… and developments related to changes in the OTD model

Ratings in structured finance: what went wrong and what can be done to address shortcomings? revisits a topic the Committee discussed in its 2005 working group report *The role of ratings in structured finance: issues and implications.* The current report draws on the lessons learnt during the turmoil about the vulnerabilities of ratings of structured finance (SF) products. It highlights the risk factors that are likely to have contributed to the poor rating performance of SF products backed by US subprime mortgages. These include credit rating agencies (CRAs) underestimating the severity of the housing market downturn, model risk (the risk of using a wrong model) aggravated by limited historical data, and CRAs underestimating the originator risk factor.

CGFS revisits ratings in structured finance

The report highlights several lessons. First, credit rating information should support, not replace, investor due diligence. Second, better information on the key risk factors of SF ratings is needed. Third, CRAs should take system-wide risk into account.[7] Based on these lessons, it provides a number of specific recommendations on how the information provided on ratings of SF products can be improved. Key recommendations include the need for more user-friendly access to CRA SF models, including the sensitivity of SF tranche ratings to change central assumptions regarding default rates, recovery rates and correlations, and the need for CRAs to consider how to incorporate additionnal information on the risk properties of SF products into the rating framework.

Lessons and recommendations

The report also includes a summary of the feedback received during a consultation process with CRAs and investors. Although investors were critical of CRAs' technical failings and inadequate resources, the need for CRAs to repair their reputation was seen as a powerful force for improvements. Indeed,

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[7] CRAs should periodically consider the wider systemic implications of a rapid growth of similar instruments or vehicles, or of new business undertaken by existing vehicles, for the continued robustness of their original ratings criteria. Such growth may lead to a concentration of market and other risks that may not have been anticipated at the time the CRA's minimum requirements were formulated. As illustrated by the recent experience of structured investment vehicles (SIVs), the consequences of exposure to a common shock can be amplified when several vehicles sharing common ratings rules are simultaneously affected. This is particularly the case when market-based triggers are incorporated in the rating.

investors noted that CRAs' recent shortcomings in risk evaluation had been shared by many market participants. A number of initiatives to enhance the information provided on SF ratings are already under way. In the light of these initiatives, the CGFS will follow up with CRAs and investors on the recommendations made in the report.

CGFS issues report on central bank operations in response to the financial market turmoil

Central bank operations in response to the financial market turmoil examines how central banks have adapted their liquidity operations (the provision of central bank money to eligible financial institutions) in response to the money market tensions that emerged during the turbulence. The report was prepared by a study group convened by the CGFS in cooperation with the Markets Committee. It discusses the various measures taken by central banks,[8] assesses the outcome of these measures and sets out a number of recommendations for central bank liquidity operations.

Central banks have reduced, though not resolved, tensions in money markets

Based on the experience up to end-April 2008, the report suggests that the various central bank actions have reduced, though not resolved, tensions in the money markets. In turn, this was judged to have mitigated the potential damage to the economy from the broader financial market turmoil. Overall, the most tangible result was that central banks were able to keep short-term market rates close to their policy rate targets, notwithstanding the more volatile market conditions, as well as the stigma associated with standing lending facilities, which might have, in some cases, complicated central banks' efforts. Addressing funding market pressures in the broader sense, particularly in term unsecured markets, proved to be more difficult. This was because funding market pressures could come not only from liquidity concerns (eg due to asset market dislocations or unanticipated payment obligations affecting individual institutions), which are amenable to central bank action, but also from counterparty risk or other concerns, which are not readily addressable by central bank operations. Central bank communication during the turmoil was judged largely successful, especially in distinguishing liquidity management actions from monetary policy changes. Nonetheless, given that there were still some instances of misunderstanding about the details of policy implementation, there could be room for improvement.

Policy recommendations

The report concludes with a number of recommendations that pertain to central banks' ability to achieve their policy rate targets in times of turmoil, problems in the domestic distribution of reserves, illiquidity of financial markets or of institutions, problems in the international distribution of liquidity, risks of misinformation and misunderstanding, financial institutions' reluctance to use standing facilities (stigma) and costs associated with central bank interventions, including moral hazard. While making these recommendations, the study group emphasises that the specific ways that central banks may choose to implement them should depend upon the circumstances and the individual central bank's situation. In any event, the report reflects the study group's awareness that the recommendations it identified cannot deal with the

[8] A detailed chronology of selected central bank actions is presented in the annex of the report.

root causes and pervasive effects of the market turmoil, which go beyond the sphere of central bank actions.

The report was drafted during a time when central banks were closely monitoring market developments and, more or less simultaneously, needed to respond to the evolving challenges. Some of the specific recommendations discussed by the study group had already been implemented during the drafting period. Beyond this report, which reflects the study group's experience and assessment only up to end-April 2008, central banks will continue to draw lessons from the turmoil and to examine how their liquidity operations can be made more effective. In particular, central banks are further exploring the steps they might take to facilitate mobilising liquidity across national borders.

Committee on Payment and Settlement Systems

CPSS releases study on progress in reducing FX settlement risk …

On 14 May, the CPSS released a report on *Progress in reducing foreign exchange settlement risk*. The report was prepared for the Committee on Payment and Settlement Systems by its Sub-Group on Foreign Exchange Settlement Risk, and was first published as a consultative document in July 2007.[9] In 1996 the G10 central banks endorsed a strategy to reduce the systemic risk arising from the settlement of foreign exchange trades. The strategy was motivated by the finding that banks' foreign exchange settlement exposures[10] to their counterparties were in many cases extremely large relative to their capital, lasted overnight or longer and were poorly understood and controlled. The report analyses the progress that has been made over the past 10 years and concludes that the central bank strategy has achieved significant success, evidenced most visibly by the establishment and growth of CLS Bank, which settles on average more than $3 trillion each day in FX-related payment obligations. However, at the same time, a notable share of FX transactions is settled in ways that still generate significant potential risk across the global financial system and so further action is needed. The report therefore recommends specific actions by individual institutions, industry groups and central banks to reduce and control remaining large and long-lasting exposures and to guard against a risk of reversing the important progress already made. The special feature article on page 53 of this issue discusses the report in more detail.

… and issues report on interdependencies of payment and settlement systems …

On 4 June, the CPSS released a report on *The interdependencies of payment and settlement systems.* The report was prepared by the Working Group on System Interdependencies, in order to identify the various interdependencies that exist among the systems of CPSS countries, analyse the risk implications of these interdependencies, and assess any associated risk management challenges.

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9 See "Recent initiatives by the Basel-based committees and groups", *BIS Quarterly Review*, September 2007, pp 95–101.

10 The CPSS defines FX settlement risk as "the risk that one party to a foreign exchange transaction will pay the currency it sold but not receive the currency it bought"; see *A glossary of terms used in payments and settlement systems*, CPSS, March 2003.

The report concludes that interdependencies have important implications for the safety and efficiency of the global payment and settlement infrastructure. Tighter interdependencies among systems have contributed to strengthening the global infrastructure by reducing several sources of settlement costs and risks. At the same time, interdependencies have increased the potential for disruptions to spread quickly and widely across multiple systems.

… suggesting policy actions to reduce the potential of a disruption to spread quickly

To address the potential for a disruption to spread quickly to many systems, the report suggests that system operators, financial institutions and service providers take several actions in order to adapt their existing risk management practices to the more complex, integrated environment resulting from tighter interdependencies. To that end the report underlines the importance of broad risk management perspectives, risk management controls that are commensurate with the role played in the global payment and settlement infrastructure, and wide coordination among interdependent stakeholders. The report also suggests that central banks and other authorities review and, where necessary, adjust their policies in the light of the challenges posed by interdependencies. In this context, the CPSS will pursue a number of objectives to increase the resilience of the global payment and settlement infrastructure.

Financial Stability Forum

FSF chairman updates G8 Finance Ministers …

In his *report* made on 14 June to the G8 Finance Ministers, the Chairman of the FSF assessed the current situation in the financial system and gave an update on the implementation of the recommendations of the FSF's *Report on enhancing market and institutional resilience*. He also outlined the FSF's future work plans.

… on implementing recommendations of FSF report on market and institutional resilience

Implementation is on track for the recommendations of the FSF report identified by the G7 in April as immediate priorities. Supervisors and national authorities have strongly encouraged their internationally active financial institutions to use for mid-year 2008 financial reports the risk disclosure framework set out in the FSF report. The International Accounting Standards Board (IASB) is accelerating its work to enhance the accounting and disclosure of off-balance sheet entities; it has set up an expert advisory panel which has started assisting it in (a) reviewing best practices in the area of valuation techniques and (b) formulating any necessary additional guidance on valuation methods for financial instruments and related disclosures when markets are no longer active. On 16 April, the BCBS announced a series of steps to make the banking system more resilient to financial shocks, including quidance to strengthen risk management and supervisory practices.[11] It also issued for public consultation global sound practice guidance on the management and supervision of liquidity risks (see above). Lastly, IOSCO finalised the revision

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[11] See *BIS Quarterly Review*, June 2008, pp 81–4.

to its Code of Conduct Fundamentals for Credit Rating Agencies (CRAs), and released the revised Code on 28 May.[12]

Good progress is also being made by FSF member institutions and bodies as well as the FSF Working Group on further recommendations from the April report. The Basel Committee announced that it will publish later this year proposals for establishing higher capital requirements for complex structured credit products; strengthening the capital treatment of liquidity facilities extended to off-balance sheet vehicles; and strengthening the capital requirements in the trading book (see the above discussion on the incremental risk charge). The BCBS is also in the process of developing guidance to enhance the supervisory assessment of banks' valuation processes (see above). IOSCO decided in May to monitor the implementation by CRAs of the revised Code of Conduct Fundamentals for CRAs; it aims to have the results later this year. The Joint Forum has launched a stocktaking of the uses of credit ratings by its member authorities in the banking, securities and insurance sectors; it plans to finalise the work by end-2008. The FSF Working Group on Market and Institutional Resilience has formed a small group of supervisors to develop the protocols needed for the establishment of supervisory colleges for the major global financial institutions. Finally, at a meeting convened by the Federal Reserve Bank of New York on 9 June, major market participants and their supervisors reviewed industry strategy and agreed an agenda for addressing weaknesses in the operational infrastructure of the over-the-counter (OTC) derivatives market.[13]

Enhanced capital treatment of complex structured products, of liquidity facilities extended to off-balance sheet vehicles, and of the trading book

Agenda for addressing weaknesses in the operational infrastructure for OTC derivatives

The FSF Working Group continues to assess progress in taking forward the above and other recommendations. It is also setting in train an examination of the forces that contribute to procyclicality in the financial system and possible options for mitigating it.

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12 The Code sets out materially enhanced expectations for quality and integrity of the rating process; CRA independence and avoidance of conflicts of interest; and CRA responsibilities to the investing public and issuers.

13 The agenda includes the establishment of a central clearing house for credit default swaps (CDS); bilateral and multilateral netting of contracts; protocol for managing defaults; and targets for greater automation of trading and settlement.