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IV. Structural and regulatory developments

Initiatives by Basel-based committees and other groups

October

The Basel Committee on Banking Supervision (BCBS) released a methodology[15] for the assessment of countries' compliance with its Core Principles for Effective Banking Supervision, a set of 25 principles designed to establish a global standard for prudential regulation and supervision. The vast majority of countries with large financial systems have endorsed the core principles and have declared their intention to implement them. As a first step towards full implementation, countries should assess their current degree of compliance with the principles based on the above-mentioned methodology. The Committee sees the formulation of the methodology as an iterative process, with refinements made as experience is gained.

The BCBS and the Technical Committee of the International Organization of Securities Commissions (IOSCO) issued updated guidance to banks and securities firms on public disclosures in the areas of trading and derivatives.[16] The paper identified information which, if publicly disclosed, would assist markets and counterparties in undertaking sound risk assessment of financial institutions' trading and derivatives activities. The recommendations in the paper follow two main themes. First, institutions should provide users of their financial statements with a clear picture of their trading and derivatives activities. They should disclose meaningful summary information, both qualitative and quantitative, on the scope and nature of their trading and derivatives activities and illustrate how these activities contribute to their earnings and risk profiles. Second, institutions should disclose information produced by their internal risk measurement and management systems on their risk exposures and their actual performance in managing these exposures. Linking public disclosure to internal risk management processes would help ensure that disclosure keeps pace with innovations in risk measurement and management techniques.[17] The most recent recommendations supersede those issued by the two Committees in 1995 in connection with their first survey report on the trading and derivatives disclosures of banks and securities firms.

A working group established by the Committee on the Global Financial System (CGFS)[18] published a report on the strains experienced by global financial markets in the autumn of 1998.[19] The group assembled a large database on prices in a variety of markets, with an emphasis on indicators of credit

[15] See *Core Principles Methodology*, Basel Committee on Banking Supervision, Basel, October 1999; see also *Core Principles for Effective Banking Supervision*, Basel Committee on Banking Supervision, Basel, September 1997.

[16] See *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms*, Basel Committee on Banking Supervision and Technical Committee of the International Organization of Securities Commissions, Basel, October 1999.

[17] However, financial market participants made it clear that legal and proprietary considerations would place limitations on the amount of information which it would be practicable to disclose.

[18] The CGFS is a central bank forum established by the Governors of the G10 central banks to monitor and examine broad issues relating to financial markets and systems with a view to elaborating appropriate policy with regard to monetary and financial stability.

[19] See *A Review of Financial Market Events in Autumn 1998*, Committee on the Global Financial System, Basel, October 1999.

risk and liquidity. Members of the group also interviewed market participants to obtain their assessment of conditions during the crisis and the response of their institutions to those conditions. The report surveys the key events of autumn 1998 and discusses the underlying mechanisms that seemed to drive these events, highlighting the withdrawal of market-making institutions from risk-taking in response to perceived increases in counterparty risk. It reviews the channels through which these processes fed on themselves and spread from one market to another. While the report refrains from making specific policy recommendations, it identifies issues raised by the crisis. These include: (i) shortcomings in the risk management techniques used by financial institutions, particularly as regards the relationship between credit risk, market price risk and liquidity risk; (ii) the need for greater transparency regarding large exposures in specific markets; and (iii) the need for central banks and other authorities to improve their monitoring and analysis of financial market developments.

November

The Joint Year 2000 Council[20] set up an information sharing platform (Market Authority Communication Services) to facilitate cross-border communication among financial market authorities during the Y2K changeover period. The services included maintaining up-to-date contact lists of regulators in major markets and collecting and disseminating information on the operational status of core components of the same markets. 176 institutions from 104 countries registered as participants and the services, which were provided through website and conference call facilities, were actively used for the whole period.

The Financial Stability Forum (FSF) established and issued terms of reference for two ad hoc working groups.[21] A task force was asked to examine ways of fostering the implementation of international standards relevant to the strengthening of financial systems, and a study group was asked to review recent experience with deposit insurance schemes and to consider setting out international best practice for such arrangements. Both groups are expected to report in March of this year.

The CGFS released a report identifying general principles and making specific policy recommendations relevant to the promotion of deep and liquid government securities markets.[22] The document was based on discussions within the Committee and on an earlier report analysing the determinants of market liquidity.[23] The note identifies five guiding principles for the design of deep and liquid markets: a competitive market structure; a low level of market fragmentation; low transaction costs; a sound, robust and safe market infrastructure; and heterogeneity of market participants. It also discusses five policy recommendations for government securities markets covering debt management strategies, taxation, transparency of issuance and trading information, trading rules and infrastructure, and the development of related markets.

[20] The Joint Year 2000 Council was established in April 1998 and is sponsored by the BCBS, the CPSS, IOSCO and the IAIS.

[21] The FSF was initiated by G7 Ministers and Governors in February 1999, based on a recommendation by Hans Tietmeyer, then President of the Deutsche Bundesbank. The Forum is chaired in a personal capacity by Andrew Crockett, General Manager of the Bank for International Settlements, and comprises officials from developed and developing market economies, international financial institutions and supervisory groupings.

[22] See *How should we design deep and liquid markets? The case of government securities*, Committee on the Global Financial System, Basel, November 1999.

[23] See *Market Liquidity: Research Findings and Selected Policy Implications*, Committee on the Global Financial System, Basel, May 1999. The study, which was the result of a coordinated research effort by the central banks of Canada, Italy, Japan, the United Kingdom and the United States and the Bank for International Settlements, includes the results of a survey on the structure of government securities markets in the G10 countries and 18 individual research papers on various aspects of market liquidity.

December

The BCBS and the Technical Committee of IOSCO published their fifth annual survey on the public disclosure of trading and derivatives-related activities by major banks and securities firms in the G10 countries.[24] The exercise revealed that virtually all banks and securities firms covered by the survey disclosed information on market risk and their methods of managing it in their 1998 financial reports. Examples of common market risk information include model parameters and value-at-risk numbers generated by the models. While financial institutions generally provided information on credit risk management policies and credit exposures, information on credit risk measurement models was much less common. The majority of banks and securities firms also disclosed information on the management of liquidity and operational risk. The format of the survey was substantially updated and revised to reflect the October 1999 disclosure guidance.

The BCBS, IOSCO and the International Association of Insurance Supervisors (IAIS) announced the release of documents prepared by the Joint Forum.[25] The papers outline principles for banking, securities and insurance supervisors for ensuring the prudent management and control of risk concentrations and intra-group transactions and exposures. They form part of the compendium of documents published in February 1999 which deals with the supervision of financial conglomerates. These documents address some of the most important supervisory issues arising from the emergence of financial conglomerates and the blurring of distinctions between the activities of firms in each segment of the financial sector.

The Committee on Payment and Settlement Systems (CPSS) released for consultation *Core Principles for Systemically Important Payment Systems*. The report was prepared by a CPSS-appointed Task Force, consisting of payment system experts from 23 central banks as well as from the IMF and the World Bank. The report sets out core principles for the design and operation of systemically important payment systems and defines central bank responsibilities in applying these principles. The core principles establish a basic framework for the stable functioning of a country's payment systems. Robust and efficient payment systems are necessary to prevent systemic disruptions to financial systems, particularly in emerging markets.

Initiatives by European regulatory authorities and market participants

October

Euroclear, the Government Securities Clearing Corporation (GSCC) and the London Clearing House (LCH) announced plans for the creation of the European Securities Clearing Corporation (ESCC), a new entity for the netting of transactions in European bond markets and repurchase agreements. The facility will be based on LCH's RepoClear, a service launched in August 1999 that has so far only traded repos based on German government debt. The partners will establish cross-margining arrangements that would enable market participants to post collateral on one continent and trade on another. The agreement led GSCC and Euroclear to abandon an earlier plan to launch a separate European repo netting entity that would have competed with a facility to be introduced by Cedel and Deutsche Börse Clearing.

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[24] See *Trading and Derivatives Disclosures of Banks and Securities Firms – Results of the Survey of Public Disclosures in 1998 Annual Reports*, Joint Report by the Basel Committee on Banking Supervision and the Technical Committee of the International Organization of Securities Commissions (IOSCO), Basel, December 1999.

[25] See *Risk Concentration Principles* and *Intra-Group Transactions and Exposure Principles,* Joint Forum, Basel, December 1999. The Joint Forum was established in 1996 under the aegis of the BCBS, IOSCO and the IAIS to take forward the work of an earlier body, the Tripartite Group, in examining supervisory issues relating to financial conglomerates. It comprises an equal number of bank, insurance and securities supervisors from 13 countries.

A group of experts from the financial industry (the Giovanini Group) proposed that the European Commission help remove some of the barriers to cross-border trading in repurchase agreements.[26] The group's report noted that in spite of a satisfactory functioning of domestic repo markets, continent-wide activity was hampered by the fragmentation of the infrastructure (particularly clearing and settlement) and differences in market practices, fiscal treatments and legal frameworks.

November

The European Commission launched a round of consultations on a new capital adequacy framework for banks and investment firms. A consultative paper prepared by the Commission's services identifies a number of areas for consideration, notably credit risk, supervisory review and market discipline. The exercise complements a consultation procedure undertaken by the BCBS, which was launched on 3 June 1999. However, the European framework will cover a broader range of entities than the Basel rules, which are aimed only at large internationally active institutions. Moreover, the document proposes that the new capital adequacy framework be preferably based on internal credit ratings, in contrast to the BCBS scheme which would give banks the possibility of using either internal or external ratings. The deadline for comments was set at 31 March 2000.

Initiatives by US regulatory authorities and market participants

October

The US Securities and Exchange Commission (SEC) gave four US exchanges specialising in equity options a period of 90 days to submit a plan for the electronic linkage of their markets. Regulators are increasingly concerned that multiple listings could result in a dilution of liquidity. They believe that such an inter-market link would be critical in ensuring best execution of customer orders. However, the establishment of such a link will be complicated by the fact that exchanges have independently developed their own electronic systems. Competition in the market for equity options intensified during the summer as exchanges abandoned a tacit non-competition agreement that prohibited the multiple listing of most options. It is likely to intensify in the year 2000 with the introduction in the United States of the International Securities Exchange, an electronic facility for the trading of stock options.

November

The US President's Working Group on Financial Markets published its report on the OTC derivatives market.[27] The group recommended a number of changes to the Commodities Exchange Act (CEA – the legislation that governs the Commodity Futures Trading Commission (CFTC)), including the exclusion from the CEA of bilateral swap agreements by sophisticated market participants (other than in non-financial commodities with finite supply). The group agreed that there was no compelling evidence of problems involving bilateral swap agreements that would warrant regulation under the CEA. It noted that the sophisticated counterparties using OTC derivatives did not require the same protection under the CEA as that required by retail investors. It also argued that most of the dealers in the swap market were either affiliated with broker-dealers or were regulated by one of the relevant regulatory agencies. Lastly, the report supported improvements to legal certainty in several areas such as the electronic trading of OTC instruments, clearing houses for OTC products and hybrid securities.

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[26] See *The EU repo markets: opportunities for change*, October 1999.

[27] *Over-the-Counter Derivatives Markets and the Commodities Exchange Act*, US Commodity Futures Trading Commission, US Federal Reserve Board, US Securities and Exchange Commission and US Treasury, Washington, DC, November 1999. See also the detailed summary contained in *Swaps Monitor*, New York, 15 November 1999.

The CFTC voted to allow US futures exchanges to list new futures and options contracts without its prior approval. Exchanges will be able to list new contracts one day after having filed a description of their terms and conditions. The measure will enable the exchanges to rapidly respond to the introduction of new products by their competitors. It also submitted for public comment proposals for similar liberalisation concerning amendments in exchanges' trading rules. The CFTC would retain the authority to subsequently disapprove or alter new contracts or trading rules, but transactions already concluded would remain valid.

The US General Accounting Office released a report on the lessons learned from the near-collapse of Long-Term Capital Management (LTCM).[28] One of the main conclusions of the report is that financial regulators need to coordinate better their oversight of high-risk activities undertaken by institutions operating across the various areas of regulatory responsibility. The report noted that the LTCM crisis showed that the traditional focus of US regulators on individual institutions and markets was not adequate to identify potential systemic threats that can arise from non-regulated entities. It also highlighted that the banks and securities firms that were LTCM's direct creditors and counterparties had failed to enforce their own risk management standards. Lastly, it mentioned that the "regulatory gap" had become more significant due to the growing share of financial assets held outside regulated entities. Thus, it recommended direct regulation of unregistered affiliates of securities and derivatives firms by the SEC and the CFTC.

[28] See *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, Washington, DC, November 1999.

Chronology of major structural and regulatory developments

Month	*Body*	*Initiative*
October 1999	Basel Committee on Banking Supervision	• Release of *Core Principles Methodology*
	Basel Committee on Banking Supervision / International Organization of Securities Commissions	• Release of *Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms*
	Committee on the Global Financial System	• Release of *A Review of Financial Market Events in Autumn 1998*
	Giovanini Group	• Release of *The EU repo markets: opportunities for change,* a report recommending removal of barriers to cross-border trading in repos
	Euroclear, Government Securities Clearing Corporation, London Clearing House	• Plans are announced for the creation of the European Securities Clearing Corporation
	US Securities and Exchange Commission	• SEC requests US equity options exchanges to submit a plan for the electronic linkage of their markets.
November 1999	European Commission	• Round of consultations on a new capital adequacy framework is launched
	Committee on the Global Financial System	• Release of *How should we design deep and liquid markets? The case of government securities*
	US President's Working Group on Financial Markets	• Release of *Over-the-Counter Derivatives Markets and the Commodities Exchange Act*
	US Commodity Futures Trading Commission	• Futures exchanges allowed to list new futures and options contracts without prior CFTC approval
	US General Accounting Office	• Release of *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*
	Financial Stability Forum	• Formation of two ad hoc working groups
December 1999	Committee on Payment and Settlement Systems	• Release for consultation of *Core Principles for Systemically Important Payment Systems*
	Basel Committee on Banking Supervision / International Organization of Securities Commissions	• Release of *Trading and Derivatives Disclosures of Banks and Securities Firms – Results of the Survey of Public Disclosures in 1998 Annual Reports*
	Joint Forum	• Release of *Intra-Group Transactions and Exposure Principles* and *Risk Concentration Principles*