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IV. Structural and regulatory developments

Initiatives and reports concerning financial markets

January

The Institute of International Finance (IIF) released the results of a survey showing that emerging market economies had made progress in the provision of economic data to capital market participants.²³ The survey indicated that the Asian crisis had been followed by improvements in almost all of the 27 emerging market economies covered but that some countries still had a long way to go to meet IIF standards relating to comprehensiveness, frequency and timeliness. The IIF noted that there was scope for improvement in the reporting of external debt data (particularly short-term debt and repayment schedules) by a large number of economies. It also recommended that credit rating agencies take greater account of transparency in general and data dissemination practices in particular.

February

The Commodity Futures Trading Commission (CFTC) transmitted to the US Congress a staff report recommending changes to the regulatory structure administered by the CFTC.²⁴ The report proposes to reduce the regulatory burden faced by US futures markets by creating a more flexible framework whereby “one size fits all” rules would be replaced by general core principles. The blueprint outlines three kinds of facilities, which would be subject to various levels of oversight depending on the nature of the commodities traded and the sophistication of market participants. At the same time, the framework provides OTC markets with greater legal certainty.

The US Securities and Exchange Commission (SEC) issued a concept paper seeking comments on the rescission of Rule 390 and the issue of market fragmentation. Rule 390 bars members of the New York Stock Exchange (NYSE) from trading stocks listed before 1979 outside an established exchange.²⁵ On market fragmentation, the paper deals with a broad range of issues, including the implications of multiple trading systems and the internalisation of transactions by broker-dealers. The SEC is seeking comment on whether the lack of order interaction caused by fragmentation is or will become a problem for the markets; this issue is currently the subject of heated debate in US financial markets.

²³ See *Data Release Practices of Emerging Market Economies: 1999 Assessment*, Institute of International Finance, Washington, DC, January 2000.

²⁴ See *A New Regulatory Framework*, Commodity Futures Trading Commission, Washington, DC, February 2000. At a hearing of the US Senate Committee on Agriculture, the Chairman of the US Federal Reserve, Alan Greenspan, called on the US Congress to exempt most US OTC derivatives markets from the Commodity Exchange Act. He said that the legal uncertainty faced by market participants was posing unacceptable risks to the country's financial system and could cause the loss of profit and employment opportunities to foreign jurisdictions that maintain the confidence of investors without imposing so many regulatory constraints.

²⁵ In 1999 the New York Stock Exchange voted to rescind the rule.

The IIF and the International Swaps and Derivatives Association (ISDA) released a joint study on the multiple credit risk modelling systems used by 25 commercial banks from 10 countries.²⁶ The document is based both on surveys of the qualitative aspects of modelling systems and on a detailed quantitative testing of selected models. On the qualitative side, the report notes that the use of modelling systems is likely to increase substantially in the near future. On the quantitative front, little was said about model risk (ie the risk created by financial institutions' dependence on their own models and risk projections) but important conclusions were reached:

- When assumptions, parameters and portfolios are standardised, outputs are broadly similar when the same version of the model is used
- Models yield directionally consistent outputs when given similar inputs
- Within model types, most differences in output reflect differences in model inputs, preprocessing, valuation and errors in model usage during testing
- Some differences in model outputs could also be attributed to differences in the analytical engines used and in versions of the same model

March

The Committee on the Global Financial System (CGFS) of the G10 Governors released a report on stress testing by large financial institutions.²⁷ The group investigated the use of stress testing and explored the possibility that aggregating the results of financial firms' stress tests might produce information of use to central banks, other financial regulators and private sector practitioners. Drawing on interviews with risk managers at large, internationally active financial institutions, the group concluded that stress testing is likely to remain an important element of the risk management strategies of large financial firms. The first chapter of the report summarises current practice in stress testing and discusses some of its limitations. With regard to the aggregation of stress test results, the group concluded that while, under ideal circumstances, aggregate stress tests could potentially provide useful information in a number of areas, it is as yet unclear whether those circumstances prevail. Some of the considerations which might be involved in setting up an aggregate stress test exercise, and the limitations to the potential usefulness of such an exercise, are examined in the second chapter. The report recommends conducting a one-off survey of the scenarios used by risk managers. Such a survey would add to the overall transparency of the risk management process and allow firms to improve information-sharing, at a relatively low cost in terms of reporting burden.

The Financial Stability Forum (FSF) held its third meeting and exchanged views on potential threats to the stability of the international financial system.²⁸ The FSF received reports from three working groups set up at its first meeting in April 1999 to address concerns related to highly leveraged institutions (HLIs), capital flows and offshore financial centres (OFCs), and endorsed their recommendations together with concrete policy actions.²⁹

- The working group on HLIs recommended a package of measures to address both systemic risk and market dynamics concerns arising from the activities of HLIs (especially hedge

²⁶ See *International Banks to Strengthen Use of Portfolio Credit Risk Modelling Systems*, IIF-ISDA, London, Washington and New York, February 2000.

²⁷ See *Stress Testing by Large Financial Institutions: Current Practice and Aggregation Issues*, Committee on the Global Financial System, Basel, March 2000.

²⁸ Established by the G7 in February 1999, the Forum aims to promote international financial stability through enhanced cooperation in financial supervision and surveillance. It comprises national authorities responsible for financial stability in significant international financial centres, international financial institutions, international supervisory and regulatory bodies, and central bank expert groupings. The Forum is chaired by Andrew Crockett, General Manager of the Bank for International Settlements, in a personal capacity.

²⁹ The three working group reports are available on the FSF website (www.fsforum.org).

funds). The measures include strengthened risk management practices by HLIs and their counterparties, enhanced regulatory oversight of HLI credit providers and enhanced public disclosure by HLIs and other counterparties.³⁰ The group also considered, but did not recommend, direct regulation of currently unregulated HLIs. The FSF emphasised that direct regulation would be reconsidered if, upon review, the implementation of the report's recommendations was not adequately addressed.

- The working group on capital flows recommended that national authorities put in place a risk management framework for monitoring and assessing the risks created by large and volatile capital flows. The group pointed to important ways in which national authorities and international bodies should support this process, for example by addressing gaps in available statistics, encouraging greater transparency and eliminating laws and regulations that inadvertently encourage imprudent behaviour.
- The working group on OFCs concluded that enhanced implementation of international standards by OFCs, particularly as regards regulation and supervision, disclosure and information-sharing, would help address concerns about some OFCs. The group's recommendations spell out a process for assessing adherence to international standards, identify standards for priority implementation and propose a menu of incentives that could be applied to encourage compliance.

ISDA published the results of its most recent collateral survey, which found that the management of credit limits was a key factor driving the development of collateral management.³¹ Expanded credit capacity, increased liquidity and savings on capital costs were other important determinants of growing collateral use. However, the document also noted that legal uncertainty, infrastructure limitations, lack of expertise and the narrowness of collateral eligibility tables were the principal constraints on further market expansion.

Initiatives and reports concerning financial institutions

January

The Basel Committee on Banking Supervision (BCBS) issued two consultative papers that added further detail to proposed amendments to the Capital Accord released in June 1999. The first document puts forward guidelines for the disclosures that banks should make in order to advance the role of market discipline.³² It covers three areas: capital structure, risk exposures and capital adequacy. Fact-finding surveys conducted by the BCBS show that there are significant gaps in the information currently disclosed. The recommendations made in the paper are aimed at closing these gaps and at increasing transparency and comparability. The second paper assesses current practice in banks' internal rating systems and processes.³³ The BCBS's Models Task Force is seeking to develop an alternative approach for minimum capital requirements, based on banks' internal credit ratings, while also reviewing the existing standardised capital requirements for credit risk.³⁴ The report presents the

³⁰ US legislators are considering a bill calling for new disclosure requirements for the largest US hedge funds. In its current form, the proposed legislation would require quarterly reporting of items such as total assets, leverage ratios and market risks. The bill would be aimed at funds with total assets of more than \$3 billion or net assets of more than \$1 billion.

³¹ See *ISDA Collateral Survey 2000*, International Swaps and Derivatives Association, London and New York, March 2000.

³² See *A New Capital Adequacy Framework: Pillar Three, Market Discipline*, Basel Committee on Banking Supervision, Basel, January 2000.

³³ See *Range of Practice in Banks' Internal Rating Systems*, Basel Committee on Banking Supervision, Basel, January 2000.

³⁴ In spring 1999 the Basel Committee's Models Task Force received a mandate to embark on a study of banks' internal rating systems and processes, and to evaluate the options for relating internal ratings to a regulatory scheme.

preliminary findings of the Task Force in developing this approach - including an assessment of current practices in rating systems and processes, and the range of practices across institutions. While it appears that there is currently no single standard for the design and operation of an internal rating system, a small number of alternative approaches emerged from the Task Force's analysis.

The Capital Group of the BCBS released a paper on issues relating to credit risk mitigation techniques as a basis for discussion between the bank supervisors of the G10 countries and industry associations within their jurisdiction.³⁵ The purpose of the Group's work was to seek information on how credit risk mitigation techniques are used within risk management systems and to elicit some initial thoughts on the issues discussed in the proposed amendments to the Capital Accord.³⁶ The document is divided into two main parts. The first covers general points on the use of credit risk mitigation techniques by banks and their treatment under the Capital Accord. The second discusses various topics such as residual risks, the extent of risk reduction and issues relating to individual credit risk mitigation techniques. The BCBS believes that the capital framework should include better recognition of risk mitigation techniques, reflecting the significant increase in recent years in the use and range of such techniques, as well as in the ability to manage the associated risks.

The BCBS published an anniversary review of the steps that banks and supervisors have taken since the publication of *Sound Practices for Banks' Interactions with Highly Leveraged Institutions* in January 1999.³⁷ The review, which is based on an informal survey, reveals that both banks and supervisors have responded to the risks posed by HLIs following the near collapse of Long-Term Capital Management in autumn 1998. Progress has been made with respect to banks' awareness of the potential risks in dealing with HLIs, due diligence in credit policies, collateral management arrangements and risk measurement practices. Supervisory authorities have taken various steps to inform the banking institutions under their jurisdiction of the BCBS's concerns and recommendations. Some supervisors have included a review of banks' risk management policies and practices with respect to HLIs in their regular on-site examinations, while others have also requested detailed exposure information on banks' lending to HLIs or on their exposures arising from derivatives and other transactions. However, the Committee believes that further efforts are required to lock in improvements in banks' risk management approach, including in technical areas such as potential future exposure measurement, collateral management and stress testing.

February

As part of ongoing efforts to strengthen banks' risk management, the BCBS released a paper outlining sound practices for the management of liquidity.³⁸ Liquidity is considered crucial to the ongoing viability of any bank, but its importance transcends the individual bank since a shortfall at a single organisation could have systemic repercussions. The proper management of liquidity is therefore vital. Over time, there has been a declining ability to rely on core deposits and an increased reliance on wholesale funding. Recent technological and financial innovations have provided banks with new ways of funding their activities and managing their liquidity, but the recent turmoil in global financial

³⁵ See *Industry Views on Credit Risk Mitigation*, Capital Group, Basel Committee on Banking Supervision, Basel, January 2000.

³⁶ In its paper *A New Capital Adequacy Framework*, the BCBS indicated that it plans to refine its approach to the treatment of credit risk mitigation techniques in the banking book.

³⁷ See *Banks' Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee's Sound Practices Paper*, Basel Committee on Banking Supervision, Basel, January 2000.

³⁸ See *Sound Practices for Managing Liquidity in Banking Organisations*, Basel Committee on Banking Supervision, Basel, February 2000.

markets has posed new challenges for liquidity management. In the light of these developments, the new paper supersedes the Committee's 1992 liquidity framework.³⁹

In an attempt to close existing loopholes, US federal banking regulators⁴⁰ proposed new capital rules for asset securitisation. The new regulations would impose higher capital requirements on banks that provide loss protection for investors in asset-backed securities (ABSs). In order to entice investors to purchase ABSs, banks that originate such transactions usually agree to absorb credit-related losses on the underlying assets by retaining the riskiest tranches of the securities. Under current rules, full capital backing is required for assets sold with such recourse. However, banks have been able to reduce their capital charges by using third-party credit enhancements, for which capital has to be held only against the face amount of the assets rather than against their full value. Under the proposed rules, the capital charge against these credit enhancements would be increased to the same level as that for assets sold with recourse. The proposals would also link capital charges to securities ratings.

In response to a report of the President's Working Group on Financial Markets,⁴¹ five hedge funds released a document setting out sound risk management practices for the hedge fund industry.⁴² The document also complements the work of the Counterparty Risk Management Policy Group, which addressed many of the same issues from the perspective of credit providers.⁴³ The hedge funds recommend inter alia that:

- Senior management should allocate capital and risk on the basis of defined investment objectives and risk parameters, and control the allocation based on information supplied by an independent risk monitoring function
- Hedge fund managers must recognise that market, credit and liquidity risks are interrelated, requiring the hedge fund manager to analyse the consequences of the fund's exposure to these combined risks
- Fund managers should assess how funding liquidity may be compromised during periods of stress and seek to establish reliable sources of financing in order to enhance financial stability in volatile market conditions
- Managers should focus on measures of leverage that relate the riskiness of the portfolio to the ability of the fund to absorb that risk, or risk-based leverage

Initiatives and reports concerning market infrastructure

March

Euroclear, the Brussels-based international clearing house, and SICOVAM SA, the French clearing house, announced a full merger of their operations. The combined firm, which will be called Euroclear Clearance System PLC, will be the world's largest international clearing and settlement organisation, ahead of Clearstream, created by an earlier merger of Cedel SA and Deutsche Börse Clearing, and the

³⁹ See *A Framework for Measuring and Managing Liquidity*, Basel Committee on Banking Supervision, Basel, September 1992.

⁴⁰ The Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

⁴¹ See *Hedge Funds, Leverage and the Lessons of Long-Term Capital Management*, President's Working Group on Financial Markets, Washington, DC, April 1999.

⁴² See *Sound Practices for Hedge Fund Managers*, Caxton Corporation, Kingdon Capital Management LLC, Moore Capital Management Inc, Soros Fund Management LLC and Tudor Investment Corporation, New York, February 2000.

⁴³ See *Improving Counterparty Risk Management Practices*, Counterparty Risk Management Policy Group, New York, June 1999.

Settlement Alliance, formed by CrestCo Ltd of the United Kingdom and SIS SegalInterSettle of Switzerland. The firm is expected to become clearer for Euronext, the stock exchange alliance launched in March by the Belgian, Dutch and French stock markets.

Chronology of major structural and regulatory developments

Month	Body	Initiative
January 2000	Basel Committee on Banking Supervision	<ul style="list-style-type: none"> Release of <i>A New Capital Adequacy Framework, Range of Practices in Banks' Internal Rating Systems, Industry Views on Credit Risk Mitigation and Banks' Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee's Sound Practices Paper</i>
	Institute of International Finance	<ul style="list-style-type: none"> Publication of <i>Data Release Practices of Emerging Market Economies, 1999 Assessment</i>
February 2000	Basel Committee on Banking Supervision	<ul style="list-style-type: none"> Release of <i>Sound Practices for Managing Liquidity in Banking Organisations</i>
	Institute of International Finance and International Swaps and Derivatives Association	<ul style="list-style-type: none"> Release of <i>International Banks to Strengthen Use of Portfolio Credit Risk Modelling Systems</i>
	US Commodity Futures Trading Commission	<ul style="list-style-type: none"> Release of <i>A New Regulatory Framework</i>
	US federal banking regulators	<ul style="list-style-type: none"> Proposal for new capital rules for asset securitisation
	US hedge funds	<ul style="list-style-type: none"> Release by five US hedge funds of <i>Sound Practices for Hedge Fund Managers</i>
March 2000	US Securities and Exchange Commission	<ul style="list-style-type: none"> Issuance of concept paper seeking comments on the abrogation of Rule 390 and the issue of market fragmentation
	Committee on the Global Financial System	<ul style="list-style-type: none"> Release of <i>Stress Testing by Large Financial Institutions: Current Practices and Aggregation Issues</i>
	Euroclear and SICOVAM	<ul style="list-style-type: none"> Both entities announce a full merger of their operations
	Financial Stability Forum	<ul style="list-style-type: none"> Release of reports by working groups on highly leveraged institutions, capital flows and offshore financial centres
	International Swaps and Derivatives Association	<ul style="list-style-type: none"> Release of <i>ISDA Collateral Survey 2000</i>

Refocusing the Bretton Woods institutions: the state of the debate

Philip Wooldridge

As part of ongoing efforts to strengthen the architecture of the international financial system, a number of proposals have recently been made for refocusing the International Monetary Fund and the World Bank. Since their founding at the Bretton Woods conference in 1944, the activities of the IMF and the World Bank have expanded beyond the purposes set out in their Articles of Agreement. The IMF has increasingly become involved in longer-term structural reforms and concessional lending to poorer countries, areas that have traditionally been the responsibility of the World Bank. The World Bank, in turn, has been called on to provide short-term balance of payments support to countries experiencing a temporary loss of market confidence, a role that falls under the mandate of the IMF.

To a certain extent, this expansion of activities reflects the significant changes in the global economy since the Bretton Woods conference, as well as a growing awareness of the interdependence of macroeconomic policies and structural reforms. The IMF and the World Bank have in recent years made a concerted effort to cooperate more closely with one another so as to reduce overlap and exploit synergies, especially in the areas of financial sector reform and poverty reduction. Nevertheless, there is growing support for further clarification of their respective roles.

Debate about the appropriate role of the Bretton Woods institutions focuses primarily on their lending facilities: to whom and on what terms should the IMF and the World Bank lend hard currency? Support seems to be emerging for phasing out longer-term IMF lending to countries with market access and for discouraging repeated borrowing. Beyond that, there is little agreement about the role of the IMF in long-term lending. The Group of Seven industrial countries^① stress that the IMF must continue to provide concessional assistance to poor countries. The Meltzer Commission,^② on the other hand, recommends that IMF lending be limited to the provision of short-term liquidity assistance, and that longer-term lending for poverty reduction or structural reform cease.

There is a broad consensus that, in order to mitigate moral hazard, the IMF should in most circumstances adhere to predefined lending limits^③ and take appropriate steps to involve the private sector in the resolution of crises. However, there is some disagreement about how best to translate these principles into practice. Lawrence Summers,^④ Secretary of the US Treasury, emphasises that the IMF must continue to be in a position to provide very large-scale financing in the event of a systemic crisis. The Goldstein Report^⑤ also recognises the potential need for exceptional financing, but recommends instituting special approval procedures for access above normal lending limits. With regard to private sector involvement, the G7 countries have outlined a framework intended to guide the international community's policy response to different crises, and the IMF^⑥ is building on this framework. The Goldstein Report suggests that the IMF should be prepared to support a temporary payments standstill, but the Institute of International Finance (IIF)^⑦ and other market associations stress the importance of voluntary approaches to private sector involvement. At its April 2000 meeting, the International Monetary and Financial Committee of the IMF^⑧ emphasised that the access, pricing and other aspects of official financing facilities should provide incentives for countries to take preventive measures. The Meltzer Commission proposes that the IMF lend only to countries that meet minimum prudential standards; in the event of a crisis, countries

^① Group of Seven (2000): "Statement of G7 Finance Ministers and Central Bank Governors", 15 April, <http://www.ustreas.gov/press/releases/ps556.htm>. See also Group of Seven (1999): "Report of G7 Finance Ministers to the Köln Economic Summit", 18 June, <http://www.library.utoronto.ca/g7/finance/fm061999.htm>. ^② International Financial Institution Advisory Commission, US Congress (2000): "Report to Congress", March, <http://phantom-x.gsia.cmu.edu/IFIAC/USMRPTDV.html>. ^③ The IMF's current guidelines on access limits, which were adopted in 1994, limit loans under a standby arrangement or extended Fund facility to 100% of quota annually and 300% of quota cumulatively. Access limits are reviewed periodically. ^④ Lawrence Summers (1999): "The right kind of IMF for a stable global financial system", remarks to the London School of Business, 14 December, <http://www.ustreas.gov/press/releases/ps294.htm>. See also Lawrence Summers (2000): "Testimony before the House Banking Committee", 23 March, <http://www.ustreas.gov/press/releases/ps480.htm>. ^⑤ Independent Task Force sponsored by the Council on Foreign Relations (1999): "Safeguarding prosperity in a global financial system: The future international financial architecture", October, <http://www.foreignrelations.org/public/pubs/IFATaskForce.html>. ^⑥ IMF (2000): "Report of the acting Managing Director to the International Monetary and Financial Committee on progress in reforming the IMF and strengthening the architecture of the international financial system", 12 April, <http://www.imf.org/external/np/omd/2000/report.htm>. ^⑦ Institute of International Finance (1999): "Involving the private sector in the resolution of financial crises in emerging markets", April, <http://www.iif.com/PublicPDF/EmergingMarkets0499.pdf>. ^⑧ International Monetary and Financial Committee of the Board of Governors of the IMF (2000): "Communiqué", 16 April, <http://www.imf.org/external/np/cm/2000/041600.htm>.

that had pre-qualified for assistance would receive funds without further negotiation. The Goldstein Report rejects explicit eligibility criteria, but recommends that the IMF lend on more favourable terms to countries that take effective steps to reduce their vulnerability to crises.

Proposals for refocusing the financing activities of the World Bank tend to emphasise the importance of poverty reduction and structural reform. There is little support for continued World Bank involvement in short-term crisis lending, although the IIF, among others, advocates the wider use of partial guarantees by the multilateral development banks to facilitate borrowers' return to capital markets. With respect to financial assistance for poverty reduction, the Meltzer Commission proposes that the World Bank make greater use of grants to fund improvements in health care, education and infrastructure, and stop lending to countries with high credit ratings or relatively high per capita incomes. However, G7 finance ministers and central bank governors support continued World Bank lending to countries with large numbers of people living in poverty, regardless of a country's access to capital markets or average income.

The Bretton Woods institutions have recently taken steps to respond to the various proposals for refocusing their activities. In particular, the IMF has initiated a review of its non-concessional financing facilities. Four facilities have been eliminated, and the design of the remainder is being reconsidered.