

## VI. Structural and regulatory developments

### Initiatives and reports concerning financial institutions

#### July

The Basel Committee on Banking Supervision (BCBS) released a consultative paper highlighting the importance of the work of internal auditors in banking organisations and the need for cooperation between banking supervisors and banks' internal and external auditors.<sup>76</sup> The paper, prepared by the Basel Committee's Task Force on Accounting Issues, calls for independent internal audit functions with professional competence in banks. It notes that every activity and every entity of a bank should fall within the scope of internal audit. The Basel Committee said that it was seeking comments on: (i) the definition of internal audit; (ii) the "whistle-blowing" function of internal auditors; (iii) the degree to which the internal audit function might be outsourced; and (iv) internal audit by an institution's external auditor.

#### September

The BCBS issued a revised version of its supervisory guidance on the management of settlement risk arising from foreign exchange transactions.<sup>77</sup> The guidance stresses that foreign exchange settlement risk is a form of credit risk that banks should manage, like other credit risks of a similar size and duration, through a formal process of measurement and control with active senior management oversight. It also suggests that supervisors focus on whether a bank has evaluated potential FX settlement risk reductions from netting and other private sector initiatives. The revised guidance was drawn up in close consultation with the Committee on Payment and Settlement Systems (CPSS) and builds on the work of that Committee, in particular its reports *Settlement Risk in Foreign Exchange Transactions* (March 1996) and *Reducing Foreign Exchange Settlement Risk: A Progress Report* (July 1998).

The BCBS issued two papers on the issue of credit risk. The first, *Principles for the Management of Credit Risk*, is a revised version of its guidance on credit risk management and disclosure. The paper specifically addresses the following areas: (i) establishing an appropriate credit risk environment; (ii) operating under a sound credit-granting process; (iii) maintaining an appropriate credit administration, measurement and monitoring process; and (iv) ensuring adequate controls over credit risk. The second paper, *Best Practices for Credit Risk Disclosure*, aims to promote adequate and effective transparency of banks' credit risk profiles by providing guidance to banks on useful credit risk disclosures and discussing the information needs of supervisors with respect to credit risk. The guidance covers credit risk in all types of banking activities, including lending, trading, investments, liquidity/funding and asset management. Both papers are intended to be applicable in a wide range of jurisdictions and for banking institutions of varying degrees of sophistication.

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<sup>76</sup> See *Internal Audit in Banking Organisations and the Relationship of the Supervisory Authorities with Internal and External Auditors*, Basel Committee on Banking Supervision, Basel, July 2000 (available on [www.bis.org](http://www.bis.org)).

<sup>77</sup> See *Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*, Basel Committee on Banking Supervision, Basel, September 2000 (available on [www.bis.org](http://www.bis.org)).

On 20 and 21 September 2000, representatives of about 160 banking supervisory authorities from more than 125 countries met in Basel for the 11th International Conference of Banking Supervisors (ICBS) at the invitation of the Swiss National Bank, the Swiss Federal Banking Commission and the BIS.<sup>78</sup> The two main themes of the conference were the Review of the Capital Accord, and The Financial Industry in the 21st Century and the Consequences for Bank Supervision. William McDonough, the Chairman of the BCBS, said that the new Accord would be structured on the “three pillars” of minimum capital requirements, effective bank supervision and market discipline. He highlighted that the centrepiece of the new Accord would probably be the internal ratings-based approach to credit risk, which would be applicable to those institutions that have in place strong internal rating systems and controls. He mentioned that the Committee would also revise the standardised approach given that banks and supervisors in some countries did not yet have the necessary resources to implement an internal ratings approach. He said that, while the risk sensitivity of the standardised approach would be improved, the need to maintain simplicity would favour the use of external credit risk assessments. He acknowledged that such a proposal had raised concerns, such as the limited availability of credit ratings in emerging market countries and the performance record of some rating agencies in the context of recent financial crises, but he noted that few alternatives were suggested during the previous comment period. Attempts would be made to address these concerns, perhaps through the use of other indicators of a borrower’s credit quality and additional risk weights.<sup>79</sup> The Committee will also be working on other key aspects of the new framework, including assessing a capital charge for operational risk. Mr McDonough said that he expected the Committee to publish a revised version of the Accord in January 2001 and a final one in autumn 2001.

## Initiatives and reports concerning financial markets

### *August*

The Financial Stability Forum (FSF) held its fourth meeting at the BIS in Basel on 7-8 September 2000.<sup>80</sup> In addition to its regular exchange of views on developments affecting financial stability and on ongoing work by Forum members, the meeting considered a report on possible incentives to foster implementation of international standards to strengthen the financial system, the progress being made in setting out international guidance on deposit insurance schemes, and the implications of e-finance for supervision, regulation and market functioning. The FSF also reviewed progress in implementing the recommendations of the reports on highly leveraged institutions, capital flows, and offshore financial centres that were endorsed by the Forum at its March meeting in Singapore. It welcomed the considerable progress made in a wide range of areas and emphasised the importance of keeping up the momentum in ongoing implementation efforts, including concrete actions by national authorities and the private sector.

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<sup>78</sup> These international conferences, held at two-year intervals since 1979, are designed to promote cooperation among national authorities in the supervision of international banking and to enable senior representatives of supervisory authorities from a large number of countries to exchange views on a range of current issues of common concern.

<sup>79</sup> Other suggested measures include ratings provided by export credit agencies and the use by less sophisticated banks of rating systems developed by more sophisticated banks.

<sup>80</sup> The FSF was created in February 1999 by G7 finance ministers and central bank governors to promote international financial stability through enhanced information exchange and cooperation in supervision and surveillance. It brings together on a regular basis national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF is chaired by Andrew Crockett, General Manager of the Bank for International Settlements, in a personal capacity.

## September

The Executive Board of the International Monetary Fund discussed an array of possible changes to the Fund's financing facilities. It acknowledged that the Contingent Credit Line (CCL), a new facility which was approved by the Board in April 1999, but which had not yet been used by members, had not achieved its objectives, and that a number of changes were needed to allow it to play an effective role. While the eligibility criteria for the CCL remained appropriate, the Board agreed on a major overhaul of other features of the facility in order to make it a more effective instrument for preventing crises and resisting contagion in countries pursuing sound policies (including a reduction in the rate charged on CCL resources and in commitment fees). The Board also examined whether standby arrangements and the Extended Fund Facility were being used efficiently, particularly against the background of the increasing growth and integration of global capital markets. It considered amendments to these facilities aimed at encouraging countries to avoid reliance on IMF resources for unduly long periods and in unduly large amounts (including expectations of early repurchase of Fund resources and surcharges at high levels of credit outstanding). Finally, the Board examined ways of enhancing post-programme monitoring, especially when credit outstanding exceeded a certain threshold level.

The US Securities and Exchange Commission (SEC) and the US Commodity Futures Trading Commission (CFTC) agreed on an amendment to the legislation ruling futures markets. The pact reached by the agencies calls for an end to the 18-year-old ban on the trading of futures on individual stocks and for joint regulatory oversight of single stock futures and narrow stock index futures (which are both defined as security futures in the agreement). Broad-based indices will remain subject to the CFTC's exclusive jurisdiction. Single stock futures and narrow stock index contracts could be traded on both stock and futures exchanges and by both stock and futures brokers. Futures exchange had argued in favour of allowing such contracts as a means of gaining new business, while securities exchanges had expressed concerns about investor protection and unfair competition with stock options. In order to address these concerns, the new rules state that single stock and narrow index futures will fall under the customer protection provisions of US securities laws and that margin levels will not be lower than those on comparable stock options. The new measure is not intended to address the comparative tax treatment of security futures and equity options.

## Initiatives and reports concerning market infrastructure

### July

An international Task Force established by the CPSS released a consultative report setting out core principles for systemically important payment systems and guidance on the interpretation of those principles.<sup>81</sup> The principles, which are expressed in general terms, suggest key characteristics that all systemically important payment systems should satisfy. The Task Force sought comments on, inter alia, the clarity of the explanations given, the range of issues covered, particular difficulties expected to be encountered in implementing the principles, and plans for compliance with them.

The European Commission's Council of Economic and Finance Ministers appointed a seven-member group of "wise men" to review regulation and disclosure in European securities markets in the light of globalisation. The Committee on the Regulation of European Securities Markets will discuss how to implement the Financial Services Action Plan endorsed by EU leaders at their March 2000 summit in Lisbon, and designed to remove the most important barriers to a single financial market in Europe by 2005. It will: (i) report on the current status of regulation in EU securities markets; (ii) assess how regulation can best respond to developments such as cross-border stock market alliances and technical

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<sup>81</sup> The Task Force was made up of payment system experts from 23 central banks as well as the International Monetary Fund and the World Bank. See *Core Principles for Systemically Important Payment Systems*, Committee on Payment and Settlement Systems, Basel, July 2000 (available on [www.bis.org](http://www.bis.org)).

innovation; and (iii) propose scenarios to ensure greater convergence and cooperation in the day-to-day implementation of regulation. In August, the Committee sent an online questionnaire requesting suggestions on what type of regulatory arrangements would best support an integrated European securities market.

The Swiss Exchange and Tradedpoint Financial Services, the electronic stock exchange, joined forces to create virt-x, a pan-European electronic exchange for blue-chip stocks. The new exchange, which will use the Swiss Exchange's EBS trading platform, will offer a single rule book, an anonymous electronic order book, and fully integrated clearing and settlement through the London Clearing House, Euroclear, SIS SegInterSettle and Crest. The United Kingdom's Financial Services Authority will be the sole regulator. The exchange should begin its operation in the first quarter of 2001, when it will become the sole trading platform for Swiss blue-chip stocks.

Clearstream International, the clearing entity created by the merger of Cedel SA and Deutsche Börse Clearing AG, announced the launch of Creation, a new settlement platform integrating end-to-end processing through the three main functional business areas of clearing and settlement, custody and connectivity, and reporting. In addition to these core services, the platform will incorporate other aspects, including securities lending, collateral management, tripartite repo, management information systems, and billing within a unified technical architecture. Creation will replace the old Cedel legacy systems with the latest computer software and hardware. The development of the facility forms part of Clearstream International's strategy to create an integrated global securities market.

### *August*

Clearstream International and CrestCo published details of a low-cost settlement arrangement for the cross-border clearing of securities.<sup>82</sup> The solution would enable customers to settle transactions in German and UK securities (and in the relevant currencies) through the existing interfaces of Crest or Clearstream. From a customer's perspective, such an initiative would offer a single integrated trading and settlement process, minimise changes to systems and reduce the overall cost of cross-border settlement (to the same level as that of domestic trades). The settlement model would support trades with or without a central counterparty. The two groups said that the plan would be implemented independently of developments involving the London Stock Exchange.

### *September*

A working group of the Committee on the Global Financial System (CGFS) released a new report on the BIS international banking statistics.<sup>83</sup> This followed earlier work carried out by the CGFS in the wake of the Asian financial crisis, and was inspired by the perception that greater emphasis needed to be placed on the value of good financial statistics to support informed decision-making by the private sector. In the course of its deliberations, the group concluded that the consolidated banking statistics should aim to be a key source of information on the country risk exposures of internationally active banks. It was thus decided that, where feasible, consolidated banking data should cover all relevant aspects of financial institutions' exposures – including guarantees by third parties, undrawn contingent credit facilities and off-balance sheet financial contracting. In addition, the focus of the BIS statistics was to be changed so as to adopt detailed reporting of data collected on an ultimate risk basis, with a view to developing a statistical system consistent with commercial banks' own risk management practices. At the same time, the working group appreciated the importance of information on the basis of residence of the immediate borrower. Such information was crucial, for example, to enable cross-checks on country compilations of external debt statistics. The working group decided to call for a modification of the existing BIS international banking statistics and recommended the following

<sup>82</sup> CrestCo offers real-time settlement of UK, Irish and international securities.

<sup>83</sup> See *Report of the Working Group on the BIS International Banking Statistics*, Committee on the Global Financial System, Basel, September 2000 (available on [www.bis.org](http://www.bis.org)).

actions: (i) the BIS consolidated banking statistics should be restructured to present data on an ultimate risk basis; (ii) the target date for the new data series should be set at the end of 2004; and (iii) the BIS should revise its presentation of the commitment data to emphasise their interpretation as a measure of a contingent source of borrower funding and hence credit risk.

Euroclear, the international clearing house, announced a memorandum of understanding that will lead to the takeover of the clearance and settlement systems of the Belgian and Dutch stock exchanges. The move followed the earlier announcement that Euroclear would merge with Sicovam, the French central securities depository.<sup>84</sup> The consolidation of Belgian, Dutch and French clearing houses under Euroclear to create a centralised settlement facility will take place in parallel with the merger of stock exchanges from the three countries under the name of Euronext.

The proposed merger between the Deutsche Börse (DB) and the London Stock Exchange (LSE) to form iX failed to materialise. The project had faced a number of difficulties, including shareholders' concerns over corporate valuation and control of the new entity, worries that the initiative would do little to reduce clearing and settlement costs (since the exchanges had announced that they would retain their existing arrangements), fears that the separation of regulatory regimes between Frankfurt and London could not be made to work, and a perception that liquidity in mid-size companies would suffer from a split in the trading of blue-chip and growth stocks between London and Frankfurt respectively. The breakdown in the planned merger was prompted by the launch of a hostile takeover bid by OM of Sweden. Although the LSE rejected OM's offer, several other exchanges have been known to be interested in merging with the LSE. However, the success of any further merger proposals will continue to depend on a successful resolution of many of the issues raised by the initial merger proposal between the DB and the LSE. Difficulties in ironing out differences between existing exchanges might provide the opportunity for successful market entry by new electronic marketplaces operating under a single rule book and regulator.

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<sup>84</sup> The definitive merger agreement between the two entities was signed in September. From early next year, Sicovam will become Euroclear France, a wholly owned subsidiary of Euroclear Bank.

### Chronology of major structural and regulatory developments

Month	Body	Initiative
<b>July 2000</b>	Basel Committee on Banking Supervision	<ul style="list-style-type: none"> <li>Releases <i>Internal Audit in Banking Organisations and the Relationship of the Supervisory Authorities with Internal and External Auditors</i></li> </ul>
	Committee on Payment and Settlement Systems	<ul style="list-style-type: none"> <li>Releases <i>Core Principles for Systemically Important Payment Systems</i></li> </ul>
	European Commission's Council of Economic and Finance Ministers	<ul style="list-style-type: none"> <li>Appoints the Committee on the Regulation of Securities Markets</li> </ul>
	Swiss Exchange and Tradepoint	<ul style="list-style-type: none"> <li>Announce the creation of virt-x, a pan-European exchange for blue-chip stocks</li> </ul>
	Clearstream International and Deutsche Börse Clearing	<ul style="list-style-type: none"> <li>Announce the launch of Creation, a new joint settlement platform</li> </ul>
<b>August 2000</b>	Financial Stability Forum	<ul style="list-style-type: none"> <li>Fourth meeting held at the BIS</li> </ul>
	Clearstream and CrestCo	<ul style="list-style-type: none"> <li>Publish details of a low-cost settlement arrangement for the cross-border clearing of securities</li> </ul>
<b>September 2000</b>	Basel Committee on Banking Supervision	<ul style="list-style-type: none"> <li>Releases <i>Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions</i></li> </ul>
	Basel Committee on Banking Supervision	<ul style="list-style-type: none"> <li>Releases <i>Principles for the Management of Credit Risk and Best Practices for Credit Risk Disclosure</i></li> </ul>
	Basel Committee on Banking Supervision, Swiss National Bank and Swiss Federal Banking Commission	<ul style="list-style-type: none"> <li>Hold the 11th International Conference of Banking Supervisors</li> </ul>
	Committee on the Global Financial System	<ul style="list-style-type: none"> <li>Releases <i>Report of the Working Group on the BIS International Banking Statistics</i></li> </ul>
	International Monetary Fund	<ul style="list-style-type: none"> <li>Agrees on an overhaul of the IMF's financing facilities</li> </ul>
	US Securities and Exchange Commission and US Commodity Futures Trading Commission	<ul style="list-style-type: none"> <li>Agree on an amendment to the regulation of US futures markets</li> </ul>
	Euroclear and Belgian and Dutch stock exchanges	<ul style="list-style-type: none"> <li>Euroclear takes over the clearance and settlement systems of the Belgian and Dutch stock exchanges</li> </ul>
	Deutsche Börse and London Stock Exchange	<ul style="list-style-type: none"> <li>Collapse of planned merger</li> </ul>