

THE PRUDENTIAL SUPERVISION
OF NETTING, MARKET RISKS AND
INTEREST RATE RISK

Preface to

Consultative proposal by the
Basle Committee on Banking Supervision

Basle

April 1993

PREFACE

1. The Basle Committee on Banking Supervision¹ under the Chairmanship of Mr. E. Gerald Corrigan, President of the Federal Reserve Bank of New York, is today issuing for comment a package of supervisory proposals dealing with netting and market risks, together with an interim approach for the measurement of interest rate risk. Although each of these papers represents a discrete proposal, there are linkages in the implications they would have for banks' adherence to supervisory standards and requirements. The Committee has therefore decided to issue all three papers simultaneously.
2. The issue of the papers has been undertaken with the agreement of the central-bank Governors of the G-10 countries. Comments on the proposals are invited by end-December 1993.
3. The principal objective of the consultative process is to solicit the insights and judgement of private sector institutions and practitioners on the substance of the proposals, particularly in so far as they apply to the dual objectives of meaningful prudential standards and further movement towards regulatory convergence and competitive equality. The Committee recognises that some institutions may face problems in the application of the proposals. One of the objectives of the consultative procedure is to identify the nature and cause of these difficulties and any resulting compliance problems.
4. The package contains proposals for certain modifications to the Basle Capital Accord² of July 1988 which will affect institutions' capital

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- 1 The Basle Committee on Banking Supervision is a Committee of banking supervisory authorities which was established by the central-bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom, and the United States. It usually meets at the Bank for International Settlements in Basle.
 - 2 In July 1988 the Basle Committee established a common measurement system and a minimum standard for the capital adequacy of international banks in the Group of Ten countries. These arrangements, commonly referred to as the Basle Accord, came into full force at the end of 1992 and have been adopted by numerous other countries.

requirements. The market risk proposals could result in a higher or lower aggregate capital requirement, depending on the risk profile of the individual institution. This is because some of the requirements will substitute for existing credit risk requirements. Moreover, banks may have reduced overall capital charges under the netting proposal to the extent that they have legally valid netting arrangements governing their trading in certain financial instruments. The proposals for interest rate risk do not involve capital charges because they address only the measurement of interest rate risk.

I. Netting

5. The proposal on netting defines the precise conditions under which banks would be permitted to net the credit risks arising from trading in certain financial instruments under the Basle Capital Accord of July 1988. The conditions laid down extend and define more clearly the present netting arrangements in the Accord (these conditions are consistent with the principles laid down in the Lamfalussy report by the Committee on Interbank Netting Schemes published in November 1990). The paper contains a proposed text to amend the Accord in order to recognise certain bilateral netting arrangements. The paper also indicates the Committee's preliminary thinking on the conditions under which multilateral netting might be recognised for capital measurement purposes at some future date.

6. Following the consultation period, it is expected that the proposals for bilateral netting would be implemented relatively rapidly.

II. Market risks

7. The work by the Basle Committee on market risks has been in progress for several years, having started in earnest when the Basle Capital Accord was finalised in July 1988. It was clear at that time that banks' trading activities were expanding rapidly, particularly in the derivative markets, and that the Accord's focus on credit risk would need to be widened, in due course, to encompass market risks. The Committee is now proposing that specific capital charges should be applied to open positions (including derivative positions) in debt and equity securities in banks' trading portfolios and in foreign exchange. Securities held in banks' investment accounts would continue to be covered by the counterparty credit risk requirements of the present Accord and would also become

subject to the measurement of interest rate risk described in the third paper in the package.

8. Parallel work in two other fora have interacted with and influenced the development of capital requirements for banks' market risks. One has been the European Community's attempts to establish a single market in banking and finance. Because of the need perceived in Europe to create a level playing-field between banks and non-banks operating in the same securities markets, the Community has enacted a Capital Adequacy Directive which applies to both banks and securities firms. The coverage of this Directive is rather wider than the Basle Committee's present proposals but in general the methodology and much of the detail in the Capital Adequacy Directive is similar to the approach favoured by the Basle Committee since the outset of its work. Where there are significant differences, notably in the treatment of foreign exchange risk and position risk in equities, the Basle Committee favours a stricter prudential standard for banks. Banks are invited to comment on any problems that may arise from the need to comply with two regimes. The Committee is resolved to collaborate with its colleagues in Brussels with a view to achieving closer convergence.

9. The second forum in which parallel work has been in progress is the Technical Committee of the International Organisation of Securities Commissions, which began to discuss the possibility of common minimum standards for securities firms at that Committee's first meeting in July 1987. The Basle Committee was naturally interested in this project and joint work was undertaken with a view to developing common minimum charges for banks' and securities firms' positions in traded debt securities and equities and related derivative instruments. Unfortunately, these discussions have not led to a successful result because IOSCO has been unable to reach agreement within its own group.

10. While regretting the inability of IOSCO to associate itself with these specific proposals, the Basle Committee has decided to proceed with publication of the proposals because of the urgency of obtaining systematic input from banking institutions and practitioners. The banking industry is the focus of the consultation process. However, in anticipation of broader-based convergence, the overall approach has been designed with a view to its ultimate application to a wider spectrum of institutions.

III. Interest rate risk

11. The market risk proposals to apply capital requirements to debt securities in banks' trading portfolios do not address the overall interest rate risks run by banks, i.e. the risk that a change in interest rates might adversely affect a bank's financial condition through its effect on all interest-related assets, liabilities and off-balance-sheet items, including the securities which are not held in the trading account. Interest rate risk for a bank is a much wider issue and raises many difficult measurement problems. At the same time, it is a significant risk which banks and their supervisors need to monitor carefully. Analytical work has been going on for a number of years to measure interest rate risk and the progress of this work is described in the third paper in the package.

12. This paper clearly indicates that it is the intention of the Basle Committee to develop a measurement system rather than an explicit capital charge for interest rate risk. Recognising that a certain degree of interest rate mismatching is a normal feature of the business of banking, the Committee holds the view that the existing capital requirements can be regarded as providing adequate protection against interest rate risk exposure in most situations. The measurement system is designed to identify institutions that may be incurring extraordinarily large amounts of interest rate risk. Within that context, it would be left to national authorities to determine what if anything might be done. The range of responses by national authorities might include an explicit capital charge on a case-by-case basis, but the situation could also be dealt with by a number of other supervisory remedies.

13. Following consultation on this paper, it is the intention of the Committee to seek to establish a common reporting framework for interest rate risk as a basis for developing, over time, a common approach to the measurement of the risk.

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14. Members of the Basle Committee are issuing these papers in their respective countries. The consultative process will be handled at national level in the first instance and the Committee will coordinate the comments and responses made to its members individually.