# Banks' Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee's Sound Practices Paper

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# Banks’ Interactions with Highly Leveraged Institutions: Implementation of the Basel Committee’s Sound Practices Paper

## Preface

In January 1999, the Basel Committee issued a report on Banks’ Interactions with Highly Leveraged Institutions (HLIs) which analysed the quality of banks’ risk management practices with regard to HLIs and discussed the related supervisory and regulatory issues. With respect to the latter, the report described different approaches which included indirect supervisory approaches, enhanced transparency and various direct approaches. While the broader policy issues are currently being addressed by various international groupings, the Committee, through its Working Group on Highly Leveraged Institutions, has focused on monitoring the implementation of the Sound Practices paper which it issued in conjunction with its analytical report.

The various sound practices recommended by the Committee were prompted by the experience of weaknesses in banks’ risk management practices with respect to HLIs such as hedge funds, as witnessed, in particular, during the near-collapse of Long-Term Capital Management. A year after the publication of its original analysis and recommendations the Committee is providing an assessment of the response to its recommendations. This is important because HLIs can be expected to continue to expand their activities and to remain important players in the financial markets.

This anniversary review is based on the results of an informal survey carried out by banking supervisors in the G10 countries during 1999. The supervisors aimed to establish how banks in their jurisdiction have taken steps to improve the management of their involvement with HLIs. The survey recorded only a snapshot of the response by banks to the Committee’s recommendations and as a result this follow-up report should be seen as a preliminary assessment of the progress made so far. This review also incorporates the Committee’s assessment of the responses which have been formulated by various industry groups to the Committee’s analysis and recommendations. These responses accepted and confirmed, by and large, the Committee’s findings and proposals.

Over the period covered by the survey, banks appear to have considerably reduced their exposures to HLIs, although it should be pointed out that the number of banks having sizeable involvement with such institutions varies significantly from country to country. The decline in exposures may reflect a direct response to the increased uncertainty in the aftermath of the LTCM-incident. However, it is also important to evaluate banks’ behaviour in the longer run, through improvements in their risk management practices vis-à-vis HLIs.

Overall, the Committee recognises that progress has been made in this field since the release of its report in early 1999. The Committee notes the steps that have been taken by bank supervisors and individual banks in addressing the concerns that were identified in its report and in implementing its proposed sound practices. Varying degrees of progress have been made with respect to banks’ awareness of the potential risks and weaknesses in dealing with HLIs, due diligence in their credit policies for such institutions, collateral management arrangements when dealing with HLIs, and risk measurement practices. These improvements by banks play a critical role in the reduction of the potential risks posed to the financial system by the activities of HLIs.

Whereas a general consensus has emerged regarding the need for banks to improve the management of their counterparty credit exposures vis-à-vis HLIs, the development and implementation of enhanced risk measurement and management techniques has proven to be more difficult in some cases. This report therefore identifies a number of areas that require sustained attention.

Whatever the level of banks' direct exposures to HLIs, as pointed out in the Committee's report on HLIs, all banks and other market participants are likely to be affected by the second or third order effects that may result from a default of a large HLI. In addition, many of the issues identified in the Committee's report extend beyond the HLI sector and apply to the risk management of trading counterparties more generally. While the report focuses on progress with respect to HLI counterparties, its content should be seen in the light of possible future problems with all kinds of counterparties. The findings and follow-up recommendations of this report should therefore be of interest to a wide number of countries and organisations.

## I. Actions taken by supervisors

Supervisory authorities have taken various steps to inform the banking institutions under their jurisdiction of the Basel Committee's concerns and recommendations. This has generally involved written communication as well as meetings with senior management of banks. Some supervisors, particularly in those countries where banks have significant dealings with HLIs, have included a review of banks' risk management policies and practices with respect to HLIs in their regular on-site examinations. Some supervisors have also requested and obtained detailed exposure information, for instance on banks' lending to HLIs or on their collateralised and uncollateralised exposures arising from derivatives and other transactions with such institutions.

Most bank regulators have included, or intend to include, the principles of the Basel Committee recommendations in their policy guidelines. In some cases, the supervisory authorities have formally provided guidance to banks and bank examiners concerning sound practices for counterparty credit risk management. In other cases it is felt that the sound practices issued by the Basel Committee are adequately covered by existing supervisory guidelines for internal control systems and risk management procedures, though practical implementation of the guidelines is now influenced by the sound practices paper issued by the Committee.

The Committee welcomes the report on 'Hedge Funds and Other Highly Leveraged Institutions' by the International Organisation of Securities Commissions (IOSCO) that was published in November 1999. The Committee notes that the recommendations regarding prudent practices by regulated securities firms correspond with its own recommendations towards banks. Such a common approach is essential to avoid slippage of prudent practices due to competitive pressures. The Committee endorses the views expressed by IOSCO with regard to the beneficial role of public disclosure by all leveraged institutions, whether regulated or not, and supports IOSCO's recommendations in this field.

## II. Banks' assessment of the weaknesses and sound practices identified by the Committee

In general, banks and their industry organisations have welcomed the Basel Committee analysis and recommendations. The weaknesses identified in banks' risk management practices have generally been accepted by the banking industry. It is now widely held that the problems in 1998 were largely attributable to the excessive trust in the reputation of large hedge funds. This led to the compromising of internal control standards in circumstances of excessive leverage and a lack of transparency and disclosure by HLIs. Competitive pressures had led some banks to compromise critical elements of effective risk management, including upfront due diligence, exposure measurement methodologies, the limit setting process, and ongoing monitoring of counterparty exposures. Banks had relied too heavily on collateralisation of direct mark-to-market exposures and had not adequately captured the impact of secondary exposures and stressed market conditions when making their counterparty risk assessment.

The Committee is pleased that banks' awareness of the potential risks and weaknesses in dealing with HLIs has risen noticeably and that momentum has developed to address these more explicitly in banks' internal control and risk management systems. It is encouraging, for instance, that banks recognise the importance of improving credit exposure measurements such as Potential Future Exposures (PFEs), and the need for more comprehensive stress testing. However, the speed with which banks have moved to put these techniques into practice has varied across institutions. At the same time the Committee remains concerned that market pressure and competition could lead to a renewed loosening of counterparty due diligence standards and a reduction in banks' efforts to make the improvements in risk measurement and management identified as necessary in the Committee's recommendations. It will therefore monitor closely whether improvements in risk management and controls are sustained.

The Committee, through its HLI Working Group, has reviewed a number of the major reports that have been published by various industry groups in response to the Committee's Sound Practices document. These include the report 'Improving Counterparty Risk Management Practices' by the Counterparty Risk Management Policy Group (CRMPG) in June 1999; the 'Report of the Task Force on Risk Assessment' by the Institute of International Finance; and the ISDA '1999 Collateral Review'.

The Committee notes that the analysis relating to risk management practices carried out by these various groups broadly confirms the findings and recommendations of the Basel Committee's January 1999 report. In line with the Committee's view, the private sector reports recognise that many of the issues go beyond banks' involvement with HLIs, and concern counterparty risk management more generally.

The report issued by the CRMPG in particular offers a timely analysis of the work that still has to be done in the field of counterparty risk management. It confirms the Committee's emphasis on the importance of meaningful information flows from HLIs as a basis for effective counterparty credit assessments. It also makes the important observation that adequate arrangements need to be in place to ensure that the information received is not shared with the credit provider's risk taking units.

To enhance the information flows from regulated firms to regulators, the report outlines a proposed standard format under which financial institutions could, on a voluntary basis, provide regulators with quantitative information on large counterparty exposures. The report argues that such information should be provided only to the primary regulator. In addition, the report proposes meetings between senior risk managers and their regulatory counterparts to discuss systemic risk issues, but that these meetings be limited to a small number of representatives. The Committee supports enhanced information exchanges between financial institutions and their regulators and that these be done as efficiently as possible. However, the Committee is of the opinion that regulators should have access to all relevant information in possession of firms as and when required. While the main relationship will be with the "primary regulator", the Committee notes that for globally active firms other supervisors have responsibilities for branches and subsidiaries and that firms should be prepared to provide information on an entity by entity basis to non-primary regulators where necessary. The Committee also underscores the importance of enhanced public disclosure practices by all major players in the financial market and the work of the Multidisciplinary Working Group in this context.[1]

The various industry groupings have contributed to an improved understanding of the methodological issues associated with the measurement of leverage, and to laying the foundation for further improvements in risk management practices for counterparty credit exposures, including HLIs. The groups also made important suggestions for market improvements in the areas such as legal documentation, confirmation, and collateral management practices. The Committee encourages banking industry groups to continue their efforts to make progress on these various initiatives.

## III. Specific actions taken by banks to implement the sound practices

In its Sound Practices Paper the Basel Committee identified the following six major areas where banks needed to continue their efforts to strengthen their risk management practices regarding their involvement with HLIs (1) banks' overall credit risk strategy; (2) the information gathering and due diligence processes to address risks associated with HLIs; (3) the measurement and control of credit exposures; (4) the limit setting process; (5) the use of collateral, early termination and other contractual provisions to limit potential losses; and (6) the ongoing monitoring of positions vis-à-vis HLIs. The Committee pointed out that the issues were not unique to banks' interactions with HLIs but were applicable to counterparty risk management more generally. Specific actions taken by banks to implement the individual sound practices are discussed below.

### 1. Banks' involvement with HLIs and their overall credit risk strategy

The Committee stated that banks should have clear policies to govern their involvement with high-risk institutions such as HLIs and that these should be consistent with their overall credit

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[1] This Working Group, which is an initiative by the Committee on the Global Financial System (CGFS) and is chaired by Mr Fisher of the Federal Reserve Bank of New York, will assess the feasibility and utility of enhanced public disclosures by financial institutions, develop a draft disclosure template, and conduct a voluntary pilot study with market participants.

risk strategy. Risk management approaches should also be consistent with their involvement with HLIs.

Following the LTCM incident, banks generally have been reviewing their strategies and have more clearly codified their approach to HLIs. In some cases this has resulted in a decision to significantly reduce involvement with HLIs, either in terms of lending policies or the willingness to accept HLIs as trading counterparties. In other cases, emphasis has been put on ensuring that all credit exposures to HLIs are approved by senior credit committees at head offices.

To the extent that the revision of banks' strategies vis-à-vis HLIs might have reflected a temporary reduction in risk appetites following the LTCM incident, there is a possibility that business levels could increase again without appropriate changes in risk management systems and controls. There are some indications, for instance, that competitive and business pressures are starting to re-assert themselves and may be influencing credit standards imposed by banks in their dealings with HLIs.

## 2. Information gathering, due diligence and credit analysis of HLIs

The Committee emphasised that banks dealing with HLIs should employ sound and well-defined standards for credit analysis which should address the specific risks associated with HLIs. In particular, it stressed that banks should be fully familiar with the activities of their HLI counterparties and request comprehensive financial information from such counterparties, covering both on and off-balance sheet positions, in order to understand the overall risk profile of the individual institutions. The Committee also noted that the credit assessment of HLIs and the monitoring and control of the associated counterparty risks can be more complex and time-consuming than credit management in respect of other, more conventional, counterparties.

Banks involved with HLIs are reported to have improved their due diligence with respect to such counterparties. Some banks have developed new standards for credit assessment of HLIs, particularly with respect to internal risk management procedures and operational practices. Some have also increased the frequency of discussions with fund managers and expanded the number of meetings at senior levels.

To some extent banks seem to have been successful in obtaining better information from HLIs, for instance on their leverage and value-at-risk measures. Some HLIs have been pro-active in assisting this process, possibly as a defensive measure after the LTCM incident. In some cases banks have involved market risk personnel to assist credit analysts to assess the information received from HLIs. In general, banks now seem less inclined to take the information submitted by HLIs at face value and are focusing increasingly on getting a real understanding of their HLI clients' business. Despite these positive developments the Committee remains concerned that the information received by some banks may still not be adequate to make meaningful credit assessments for all HLIs. In certain instances, the documentation and information requirements that serve as the basis for sound credit assessments also remain loosely addressed in banks' policies. Furthermore, the coverage of minimum information requirements beyond counterparties' legal documentation and historical financial statement information does not seem to have been sufficiently resolved by all banks dealing with HLIs.

The evidence about improved bilateral information flows by HLIs remains mixed. In general, it appears that banks have had more success in obtaining detailed financial risk information from smaller HLIs. Overall, HLIs have remained reluctant to share sensitive information about their business with their bank counterparties. They remain concerned that the sharing of proprietary information about their trading strategies could benefit banks' own trading business although formal confidentiality agreements have become increasingly common. In some cases differing perceptions of the adequacy of Chinese wall arrangements in banks has led to HLIs reducing their list of preferred broker/dealer counterparties. Many banks remain keen to trade with HLIs, resulting in competitive pressures to attract HLI business. The risk therefore remains that pressure could develop to relax documentation and information requirements on credit standards for HLI counterparties.

## 3. Exposure measurement

The Basel Committee report identified a number of specific areas in which banks' measurement techniques for exposures to HLIs could be improved. These include the development of more useful measures of potential future exposures (PFE) to provide a meaningful calculation of the overall extent of a bank's activity with a given counterparty; the development of more effective measures of unsecured exposures arising from transactions such as OTC derivatives that are subject to daily margining; and the stress-testing of counterparty credit exposures. Progress in these different areas has generally been slow as banks are finding it challenging to implement improvements in their risk management practices in the short term. In many cases, changes in information systems are required, which may be difficult to achieve in the near term as banks have devoted substantial technology resources to address Y2K-related issues. Many firms also had been awaiting the guidance of the CRMPG, which formulated more concrete proposals regarding exposure measurement techniques. Following the conceptual thinking that has taken place in 1999, the Committee expects to see more rapid progress towards implementation this year.

Some banks are only now starting to implement realistic PFE measures whilst others are trying to enhance their existing methodologies. Areas requiring further improvements include: the more frequent calculation of PFEs; the calculation of PFEs at multiple time horizons including the ultimate life of the contract; and the use of sophisticated techniques such as Monte Carlo simulations to calculate PFEs across different products. Many banks also need to enhance their approach to incorporating into their measurement methodologies the impact of netting of short and long positions and portfolio effects across products, risk factors and maturities.

Efforts have been made to implement stress testing for counterparty credit exposures. It is encouraging that senior managers at banks have become more convinced of the importance of carrying out stress tests of their counterparty credit exposures and to incorporate these into their internal risk management systems, for instance in terms of limit setting. A number of difficulties have hindered further progress. These include conceptual considerations, such as how to reflect the linkages between market, credit and liquidity risks in the stress-testing of their counterparty credit exposures, as well as system constraints and the ability to aggregate exposure data by counterparty.[2]

## 4. Limit setting

One of the Basel Committee's sound practices related to effective limit setting for banks' exposures vis-à-vis HLIs. Emphasis was placed on the need to aggregate different types of exposures in a meaningful way.

Generally banks seem to have reassessed their credit limits and other exposures vis-à-vis HLIs. In some cases, the number of HLI counterparties was reduced and some banks ended their relationship with weaker counterparties. Credit limits were also reduced in a number of instances.

However, as discussed in the previous section, many banks are struggling to enhance their exposure management techniques, in particular with respect to liquidation values under stressed and potentially illiquid market conditions. Progress in this area is particularly important as a basis for setting meaningful counterparty credit limits. The need to incorporate liquidation measures and the results of stress-testing into the limit setting process is generally recognised by banks, but more work is required in this area.

A positive development is that banks are increasingly focusing on the cost of capital and balance sheet utilisation resulting from HLI business. In some cases, for instance, refinements are being made to the capital allocation process with a view to imposing higher internal capital charges on illiquid or concentrated positions. Such initiatives should help refocus the business on risk/reward analysis and may contribute to the setting of limits.

## 5. Collateral, early termination and other contractual provisions

The Basel Committee recommended that banks interacting with HLIs should align collateral, early termination and other contractual provisions with the credit quality and characteristics of HLIs. Banks were encouraged to control credit risks more pre-emptively.

In many countries, banks have adapted their collateral policies to better reflect a counterparty's credit quality as reflected in its capital level and risk profile (e.g. VaR exposure). Banks generally have improved the day-to-day collateral management for their transactions with HLI counterparties. Many banks have been able to secure additional initial margin, in particular for new trades with HLI counterparties. Daily realignment of collateral value for mark-to-market exposures have also come to be relied upon more commonly. In some cases margining thresholds have been reduced. Finally, efforts have been made to reduce the time available for the HLI counterparties to meet margin calls. In most cases banks

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[2] It should be noted that in most cases stress testing developments at banks have focused on all counterparty exposures, not just on hedge funds or other types of HLIs.

have found it useful to extend the use of standard master agreements.[3] However, more work is needed to relate banks' collateral and margining requirements more closely to internal measures of liquidation values.

Another way of reducing unsecured exposures in OTC transactions with HLIs has been to use an early warning system to signal when additional margin requirements are not fully met by the counterparty. In some cases, models to calculate exposures, including PFEs, have been adapted to take account of the changes in the value of collateral and their effects on unsecured exposures for collateralised portfolios. The models can also be used to simulate the liquidation of the collateral portfolio integrating liquidity constraints and eroding market conditions as well as the necessary level of over-collateralisation that might be required to limit stressed-market exposures. Finally, in certain instances the type of eligible collateral for covering exposures resulting from OTC derivative and other types of trading and financing activities with HLIs has been reassessed. This has been done to take account, for instance, of the fact that collateral value could be negatively correlated with the probability of the counterparty's default or with the market values of the contracts.

Some banks have made better use of covenants to allow them to terminate contracts or to take other actions in the event of a material deterioration in a HLIs credit quality. Closeout provisions seem to remain centred around material changes in net asset values (NAV). Early warning trigger covenants at NAV levels well above those that would initiate liquidation procedures are being introduced in some cases. Transparency covenants are also being considered to protect against the failure of HLIs to report information though it remains unclear what the scope of such covenants would be.[4]

## 6. Ongoing monitoring of positions vis-à-vis HLIs

The last Basel Committee sound practices recommendation related to the process of ongoing monitoring of positions vis-à-vis HLIs. Banks should have effective monitoring systems in place to assess the creditworthiness of HLI counterparties and the development of exposures to such parties. The potential for stressed market conditions should be considered in assessing HLI risk profiles and risk management capabilities.

Most banks have not deemed it necessary to implement major changes in their internal organisation of risk management or internal control systems. The focus has been on improving due diligence guidelines for the purpose of analysing HLI counterparties, developing better measures of the unsecured part of counterparty credit exposures (including PFEs), and stress testing. However, at least in some cases special back-office procedures have been created for monitoring purposes. Also, some banks have increased the frequency with which they conduct credit reviews of HLIs. In addition, it should be noted that the quality of management reporting is closely related to the quality of exposure measurement techniques.

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[3] Firms are awaiting a more concerted industry approach to emerge from the work of ISDA and CRMPG, for instance with respect to greater flexibility and netting provisions.

[4] In some markets the value of cross-default or set-off clauses is being recognised. Few banks had these in place during 1998 but many now realise the extent to which they could reduce the duration of a termination event.

Therefore, it is to be expected that when banks implement improved and more meaningful exposure measurement techniques, they will be able to simultaneously improve the quality of their management information systems.

## IV. Areas that require sustained further attention and proposals for further action

Although progress has been made, there are a number of areas that require sustained further attention by banks, supervisors and by other international groupings. The Committee feels that efforts have to be made on an ongoing basis by banks and supervisors to lock-in and further strengthen improvements in banks' counterparty risk management procedures vis-à-vis HLIs. It is important that these efforts are undertaken against the more general background of improving risk management by financial institutions which can be expected to remain an ongoing concern of private sector firms and regulators alike.

With respect to *further actions to be taken by banks,* the Committee feels that it is important that the initial improvements in due diligence processes for establishing credit relationships with HLIs are consolidated and developed further. Improvements in the process of ongoing counterparty risk assessments also need to be consolidated.

In order to avoid a recurrence of the difficulties experienced in 1998, it is important that banks obtain and analyse adequate information from their HLI counterparties. There is clearly room for further improvement in this area, and banks and banking industry associations must make collective efforts to obtain adequate information from HLIs. Such efforts should also include demonstrable measures by banks to ensure that proprietary information about HLI trading strategies is not available to banks' own trading units.

More work needs to be undertaken to implement a number of the Committee's sound practices recommendations, particularly the development of improved exposure measurement techniques and the use of stress testing. These are complicated technical areas that have also been addressed in the various industry reports that have been published. Technical difficulties notwithstanding, the Committee feels strongly that further steps need to be taken to move significantly forward in this ongoing process. The Committee will continue to monitor closely industry progress to implement its recommendations.

Regarding *further follow up by supervisors,* initiatives can be taken at the national level through the ongoing interaction between supervisors and banking institutions. In particular, supervisors will want to ensure that they continue to have adequate information on banks' exposures to HLIs, though the way in which such information is obtained will differ from country to country. Supervisors may also continue to find it useful to share with their colleagues in other countries material information relating to banks' involvement with HLIs on a bilateral basis.

The Committee will continue to serve as a platform for the coordination of the approaches taken by G10 supervisors to strengthen banks' risk management practices vis-à-vis HLIs and counterparties more generally. The Committee's Risk Management Group will include in its scope of activities the ongoing analysis and assessment of banks' risk management practices towards HLIs. Moreover, the Committee's June 1999 Consultative Document to amend the Capital Accord proposes a stronger link between capital requirements and risk categories, and a sound and consistent approach for capital treatment of credit risk mitigation techniques such as collateral. In this context, the Committee is considering the abolition of the maximum 50% risk weighting for non-bank OTC derivative exposures and may introduce maximum collateral valuation rules on repo-transactions. Though these potential adaptations to minimum capital requirements (Pillar I of the Committee's proposed framework) are not specifically aimed at HLIs, many of the relationships between banks and HLIs involve these instruments and will consequently be affected. Moreover, the Committee is proposing, under Pillar II of its framework, to establish a more direct link between the risk profiles of individual institutions and the quality of banks' risk management procedures, and differentiated capital treatments.

Finally, with respect to *further work by international groupings*, the Committee will continue to support the cooperation that has already taken place. In order to ensure that momentum is maintained in implementing the Basel, IOSCO and CRMPG sound practice standards, particularly in challenging technical areas such as the measurement of potential future exposure and stress testing, the Basel Committee proposes to continue its collaboration with other regulatory groupings and establish a dialogue with the financial industry. The following could provide a framework for such collaboration.

It is proposed that a small sub group of the Basel committee meet with a sub group of the IOSCO Task Force on HLIs to establish common areas of interest in risk management practices of banks and securities firms in respect of their dealings with HLIs. The IAIS could also participate in such a meeting if there are particular insurance issues of concern to them.

This group would then seek periodically, and over a limited time period, to gauge progress in two areas:

(1) Assessment of industry progress on difficult technical issues such as measurement of potential future exposure, liquidity valuation, and stress testing. This could be achieved through dialogue with a small number of firms known to be active in the development of such methodologies, who could be invited to provide an update of evolving industry best practice and firm-level implementation. Such discussions would not focus on sensitive firm specific information and firm representation could be rotated to avoid invidious choices of particular relationship firms.

(2) Progress in improving risk management processes more generally. This would involve sensitive firm specific information and it would therefore not be appropriate to make such assessments through direct dialogues with firms in a group setting. Instead, members of the group would report on progress which they observe through their bilateral supervisory relationships.

The objective of the group would be to try to benchmark progress in these areas. In order to ensure that it did not become a permanent feature and outlive its usefulness, the group could meet 2 to 3 times over a period of 12 to 18 months whereafter it would automatically be disbanded unless compelling reasons were found to continue its work.

The Committee will also continue to cooperate with other international groupings, in particular the Financial Stability Forum and its Working Group on HLIs, on public policy issues relating to HLIs. The Committee will continue to contribute actively to the activities of the Forum and to joint efforts by financial market authorities to ensure that the involvement of banks, and that of other financial market participants, with HLIs is conducted under sound risk management principles, thereby contributing to financial stability.